Philip Hammond should shelve Osborne's plan to cut corporation tax

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*In the wake of Brexit, George Osborne planned to "woo business" by reducing corporation tax – already heading for 17 per cent, the lowest rate in the G20, by 2020 – to less than 15 per cent. Will Philip Hammond, the new Chancellor, now follow through this plan, and would this be a step towards making the UK a tax haven? **Judith Knott** argues that it is not, but such policies won't help the public purse.*

The new Chancellor, Philip Hammond, faces the decision of whether to follow through his predecessor's plan to reduce corporation tax. The first question to consider is whether this would signal a shift towards tax haven status for a post-Brexit UK.

What we mean by a tax haven? There isn't a single, clear-cut definition, but the "tax haven" description typically suggests a cluster of features:

- Low rates of tax (at least for some taxes)
- The existence of special tax shelters for particular kinds of income – achieving very low effective rates of tax, and not necessarily designed to attract genuine and substantive economic activity
- A culture of secrecy around banking and other wealth management.

One of these features alone wouldn't necessarily make a country into a tax haven, but the presence of two of them (e.g. arguably in Ireland and Luxembourg) starts to suggest more than the normal "fair" tax competition that has become the norm among developed countries. If the UK is heading towards ever-lower rates of corporation tax (CT), we may tick the first bullet, but what about the other two?

Following the OECD Base Erosion & Profit Shifting (BEPS) project, aimed at countering tax avoidance by multinationals, the UK has led the way in implementing measures to curb tax shelters. For example, the generosity of the “patent box” (10 per cent CT rate on patent income) has been curtailed. And most importantly, the UK’s long-standing tax shelter — massively generous interest relief for corporates, allowing them to design their own effective tax rate — is being dismantled.

The European Commission is keen for EU member states to go even further than the OECD BEPS outcomes. But the trends at OECD level, coupled with public pressure at home and the imperative to maintain tax revenues in a turbulent economic climate, are sufficiently strong to make it difficult for a post-Brexit UK to change course dramatically.

In terms of secrecy, there has again been a strong global trend since 2009 — when the OECD started to take firm action following the financial crisis — of old-established tax havens cleaning up their act on banking secrecy (e.g. Switzerland) and becoming increasingly willing to share information with tax authorities around the world.

While there’s still work to do at a global level (as illustrated by the recent “Panama papers”), and the UK has some black spots of secrecy such as property ownership, it’s hard to envisage any UK government seriously wanting to buck this trend and back-slide on OECD commitments. I would hesitate to say “never” after the events of the last few weeks, but this would cast us among the financial outlaws of the world. Does this mean that, however low the CT rate falls, it would not by itself make the UK into a tax haven — and is therefore a good idea? Far from it.

Firstly, signals and perceptions are very important, particularly in the current uncertain environment. They can work in opposite directions, compounding the destabilising impact. On one hand, companies have become highly sensitised to public sentiment around tax havens, and might be deterred from investing in very low tax regimes precisely for that reason. Conversely, those who wish to minimise their tax bills aggressively might pick up on any signals that Brexit could mean a more tolerant environment for tax avoidance. The signals would also be picked up by our global trading and investment partners, who might be tempted to retaliate – for example, by ensuring that diversion of profits to the UK triggers their anti-avoidance rules.

What about the opportunity to send a positive signal to potential investors, that Britain continues to be “open for business”? While rate cuts can stimulate investment, it’s not clear that they are always the best way of doing so, as opposed to e.g. increasing allowances for capital investment. And the timing would need to be right: promises of rate cuts by 2020 are unlikely to shore up investment through the uncertainty of the Brexit negotiations.

Secondly, CT rate cuts down to below 15 per cent would have a significant impact on the wider tax system, particularly for small businesses. Specifically, they would exacerbate the so-called “tax-motivated incorporation” problem — that is, the distortion that encourages smaller business owners to set themselves up as companies and take their remuneration as dividends rather than salary. Immediately after the last election, the new Chancellor announced increases to dividend tax rates, which took effect three months ago. These increases reduce the distortion, but they do not remove it; policy costings from last summer indicate it still costs the Exchequer over £1bn a year.

A further reduction in CT would require dividend tax rates to rise again to keep this problem in check. While there are respectable arguments for such a move, to align rates of personal tax across different forms of income, the current changes have already attracted criticism as a form of “double taxation”. Further increases would certainly not be popular with many small business owners, generally a natural constituency for the new Chancellor’s own party.

Finally, in an economy like the UK (unlike say Bermuda or Luxembourg), with public spending at around 36 per cent of GDP, Philip Hammond would have to consider how to pay for any cuts to CT. Apart from further increases to dividend taxation, one obvious place to look to balance the budget would be increases in VAT. The current rate of 20 per cent is some way below the EU average (21.5), and a 1 per cent increase could fund several percentage point cuts in CT. From an economist’s perspective this would be an ideal solution, as VAT is a much more economically efficient tax than CT. But tax policy has to temper pure economics with political reality: funding a CT cut with a rise in VAT, signalling yet more austerity for consumers in the uncertain post-Brexit economy, looks politically explosive.

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About the Author

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