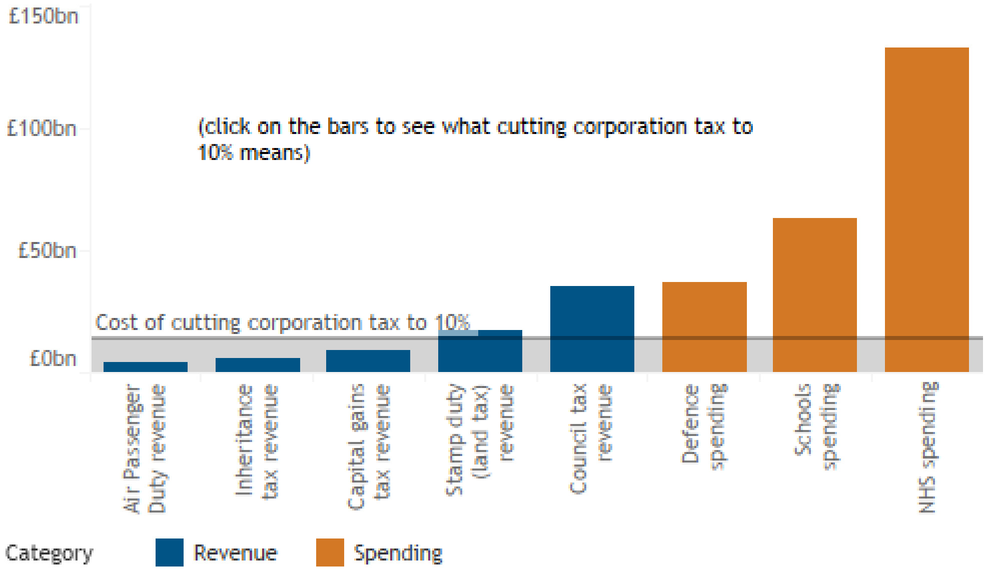
Offshore Britain?

Blog post by Adviser Leo Ringer, 26 October 2016

According to one major newspaper, the UK Government is developing a "nuclear" Brexit negotiating threat in the form of a corporation tax cut to 10%. The logic goes that the prospect of an aggressively low-tax "offshore" UK on the doorstep would scare the EU into accommodating British preferences for the future UK-EU relationship. But as with all nuclear deterrents, the question boils down to one of credibility: could and would the UK actually deliver a CT rate of 10%?

UK government revenue and spending, and the cost of cutting corporation tax



Source: Office for Budget Responsibility

Let's start with the size of the prize. Corporation tax is the UK's fourth biggest tax after income tax, national insurance and VAT, bringing in just over £40bn to the UK's coffers this year, rising to £50bn by 2020/21, or 5.9% of total revenue. The headline CT rate will fall to 17% in that year, giving the UK a further 7% to cut to reach the "nuclear" level. How much would this cost?

We know that cutting from 18% to 17% in 2020/21 will cost about £1bn, so on this maths cutting a further 7% might cost about £7bn annually. But this feels too low, against a revenue stream of £50bn. Looking at it another way, taxing the same profits base at 10% rather than 17% should bring in 60% of the higher-rate yield. Applied to the £50bn figure means losing out on around £20bn of revenue, if 10% was reached in 2020/21.

But if £7bn felt low, £20bn feels high. A substantially reduced corporate tax rate would create what economists call a "dynamic effect", whereby extra economic activity, incentivised by the lower rate, partly compensates for the lower rate by growing the taxable base of profits.

So if £7bn is a floor and £20bn is a ceiling, we can call £14bn a ballpark mid-range estimate. In the context of UK fiscal policy, this is a significant annual figure which would either substantially derail deficit reduction – adding to existing post-Brexit fiscal pressures - or require offsetting spending cuts or tax rises. The prospect for either of the latter looks slim.

Chancellor Phillip Hammond has committed to a targeted *increase* in public investment, without hinting at any additional cuts to public services spending beyond the remaining, substantive reductions factored in but yet to be delivered. Tax rises elsewhere to offset a cut to a 10% rate would, to be politically digestible, have to come from business rather than households.

But with a sharp increase in the minimum wage and a new £3bn annual skills levy on employers already biting on hiring, the scope to raise employers' national insurance contributions is negligible. The recent outcry over surging business rates, sparked by the delayed revaluation of property values, makes this an equally unlikely target. No other business tax could deliver £14bn annually without being more than doubled.

The second question is whether, when it came to it, the government would choose to spend this sum on cutting corporation tax above other priorities, once the threat has played its intended part (or not) in the Brexit negotiation. The UK Chancellor will be conscious of the risks to the UK's corporate tax base at a time when some (perhaps many) international investors are said to be reassessing their UK footprint due to Brexit uncertainty. A cut to corporation tax would go some way to mitigating those risks.

Yet Chancellors would usually give their right arm to have this much fiscal leeway. Alternatives could include cancelling capital gains tax and inheritance tax completely, or eliminating the vast majority of stamp duty, the property transactions tax. Business rates could be halved, or council tax slashed by 40%. Schools funding could be increased by a third or the NHS could be put on a sustainable financial footing for a generation. These are very big political prizes, and it is not clear that once fully thought through – and once its use as a negotiating threat had expired - cutting corporation tax would top the list.