PERSPECTIVE

CENTRE FOR POLICY STUDIES

57 Tufton Street · London SW1P 3QL · Tel: 020 7222 4488 · Fax 020 7222 4388
website: www.cps.org.uk email: mail@cps.org.uk

For the economy's sake, we cannot afford not to cut taxes

RUTH LEA

INTRODUCTION

The world economy is changing significantly. Low cost and highly competitive developing countries are having an increasing impact on all developed Western economies, not least of all here in Britain. We are, *de facto*, currently exporting much of our manufacturing industry to China and other parts of the Far East. Hardly a week goes by without another announcement that service jobs are moving to India. Under these circumstances, the rich, high cost Western economies will simply have to raise their game if they are going to maintain, never mind improve, their global competitiveness. Standing still is not an option. And going backwards is even less of an option.

If the UK is going to halt, and then act to reverse, its declining competitiveness, it is clear that taxes must be reduced.

There are, of course, many contributing factors to a country's competitiveness. These include skills standards, the regulatory burden on business, the transport infrastructure and, last but by no means least, the size of the public sector and tax levels and tax rates. This CPS Perspective concentrates on the size of the public sector – especially on tax-to-GDP ratios. It shows that current global trends are for lower tax-to-GDP ratios as countries acknowledge the need to sharpen their competitiveness and act accordingly. The one major exception is the UK. If the UK is going to halt, and then act to reverse, its declining competitiveness,[1, 2] it is clear that taxes must be reduced. For improved competitiveness and, therefore, the economy's sake, the UK cannot afford *not* to cut taxes.[3]

TAX-TO-GDP RATIOS AND GDP GROWTH

Whilst it is clear that public spending on, for example, law and order, education and public health can help economic development when it starts from a low base, there is a wealth of economic analysis to suggest that, beyond a certain point, an expanding public sector "crowds out" the more dynamic and efficient private sector.[4] Much of this economic analysis indicates that once the public sector reaches around 30%,[5] further expansion, along with the requisite tax increases, damages competitiveness and GDP growth rates. As the tax share rises, an increasing proportion of the nation's income is forcibly transferred from the private sector, which has created wealth through its own enterprise, to the state, a stranger to competitive forces, which has not.

An OECD study released in 1997[6] concluded that a cut in the tax-to-GDP ratio by 10 percentage points of GDP could increase annual growth by up to ½ to 1 percentage points. The research was meticulous and, if anything, conservative in its estimates of the favourable impact of tax cuts on potential growth. Other studies show a higher impact.[7]

It is a valuable exercise to consider the implications of the OECD research. If, for example, the tax-to-GDP ratio were to be cut from the Treasury's projected 38% for the next four to five years[8] to, say, a quite feasible 33% there could be a boost to GDP growth of some ¼ to ½ percentage points each year. Instead of growing at around 2½% a year, annual GDP growth rates of 2¾% to 3% would be easily achievable. This GDP boost, compounded over the years, would significantly improve this country's overall living standards. After 20 years of annual growth of 3% rather than 2½%, GDP would be 11% higher.

The evidence that high taxes undermine competitiveness and damage growth is increasingly being acknowledged and, moreover, acted on by many OECD countries. A recent OECD paper[9] concluded that the upward trend in tax-to-GDP ratios that had been seen since 1975 had "largely come to an end", reflecting reductions in both personal and corporate tax rates in a number of member countries.

If the tax-to-GDP ratio were cut from the Treasury's projected 38% for the next four to five years to 33%, there could be a boost to GDP growth of ¼% to ½% each year.

But this is not the whole picture. A quick inspection of recently released OECD data suggests that the tax-to-GDP ratios in the majority of OECD countries have actually *decreased* between 1997 and 2004.[10] (See annex table 2.) These countries include Canada and the US; France, Germany and Italy; Denmark, Sweden and Ireland. The major exception is the UK, where the tax-to-GDP ratio has risen by 1.0% between 1997 and 2004 and expected to increase further in 2005. Other countries that have seen a rise in the tax share of GDP include Korea (from a low base), Portugal and Spain.

It should be noted that several of the countries experiencing lower tax-to-GDP ratios have also experienced worsening fiscal balances over the period and, therefore, these "improvements" will not prove to be wholly sustainable. In 1997, for example, the US's General Government financial deficit was a modest 0.8% of GDP; by 2004 it is nearly 5%.[11] Canada's experience is quite different. The lower tax-to-GDP ratios have been achieved by cutting public sector spending as a share of GDP (it can be done!) and over the period 1997 to 2004, Canada's public financial balances have improved. The UK, however, is in the unenviable position of both raising the tax-to-GDP ratio and experiencing worsening public sector financial balances, which at some point will have to be corrected by higher taxes.[12] The British economy is, quite simply, bucking the lower tax trend and, in doing so, can only lose ground in the international competitiveness stakes.

CORPORATION TAXES

On a more specific tax matter, the UK is also losing ground to its international competitors in the area of corporation tax rates. For many years the UK has, quite justifiably, prided itself on being a magnet for overseas investment, with one of the major attractions being the relatively benign and advantageous company tax regime. But this attraction is being whittled away.[13, 14] Corporation tax rates have been falling quite sharply in recent years in many OECD countries (see annex table 1), whilst British rates have been static. No OECD country, incidentally, has increased rates.

OECD data show that standard corporation tax rates fell by an average 3% between 2000 and 2003 for its member countries.[15] (See annex table 3 for details.) A fall of 3% in itself is not trivial. But what is of special note is that some countries, including some EU countries, have reduced their rates very aggressively indeed. Belgium has cut its rate by 6%, Canada by 8%, Ireland by 11½% (to a mere 12½%) and Germany by 12%.

The UK's standard corporation tax rate (at 30%) is still attractive compared with that of the US and Japan and is still marginally lower than the OECD and EU averages. (They are around 31% and 32% respectively.) But if the trend of falling corporation tax rates is maintained, as seems likely given the red-hot competition for international investment, the UK will soon find itself at a clear disadvantage.

Downward pressure on corporation tax rates will continue both within the EU and globally. The UK should respond with lower rates. It cannot afford not *to.*

As already indicated, one of the main reasons for the reductions in corporation tax has been to attract foreign direct investment (FDI). Ireland has been at the forefront of this policy and, as recently as 1 January 2003, cut its corporation tax rate to 12.5%, a rate that applies to all corporate trading profits.[16, 17, 18] The cut was approved by the EU. The policy has been a notable success and Ireland has attracted substantial FDI. It is now one of the most profitable countries, if not *the* most profitable country, for US multinationals.[19]

Ireland's ability to attract desirable FDI and its benign tax regime has undoubtedly been a contributory factor to its quite extraordinary GDP growth over the past 15 to 20 years. Between 1987 and 2003, its GDP rose from 69% of the EU-15 average to 136%.[20, 21] Even when measured by GNP, which is considered more appropriate because of its heavy dependence on foreign investment,[22] Ireland has now caught up with the EU-15 average GNP.

Several of the EU's ten new member states are also following a policy of promoting attractive corporate tax regimes in order to entice FDI. Estonia, for example, has a zero rate on retained profits and Slovakia has recently cut its corporation tax rate to 19% (from 25%).[23] Unhappily, these countries seem to be attracting criticism from Germany and Sweden (the largest net contributors to the EU budget in per capita terms), which claim that these countries should not be able to gain a competitive edge in tax terms ("unfair competition"), whilst they are receiving EU assistance for building their infrastructure. The comparison with the treatment of Ireland seems stark.

There is little doubt that these frictions within the EU on tax competition will continue and their eventual resolution can only be a matter of speculation. But one thing seems very likely indeed: that the downward pressure on corporation tax rates will continue both within the EU and globally. The UK should respond with lower rates. It cannot afford *not* to. Otherwise the UK will continue to lose competitiveness and fall behind in the FDI stakes.

CONCLUSION

If the UK is to maintain its competitiveness, boost its economy and improve living standards, future British governments must cut taxes. Cuts in corporation tax are crucial when it comes to attracting FDI.

British governments cannot afford *not* to cut taxes. If, on the other hand, they remain indifferent to international competitiveness and the future growth potential of the economy, then doubtless they will continue to tax as they please and fritter away much taxpayers' money in inefficient, if not unnecessary, public sector projects.

ENDNOTES

1. The International Institute for Management Development (IMD) ranked the UK as the ninth most competitive economy in 1997; by 2004 the UK had slipped to 22nd. See IMD, *World Competitiveness Yearbook, 2004,* IMD, 2004.
2. The World Economic Forum (WEF) ranked the UK as the fourth most competitive economy in 1998; by 2004 the UK had slipped to 11th. See WEF, *The Global Competitiveness Report 2004-2005*, WEF, 2004.
3. See also Lord Blackwell, *Why Britain can't afford* not *to cut taxes*, CPS, October 2004.
4. See Ruth Lea, *Tax 'n' spend: no way to run an economy*, CPS, July 2004, for a résumé of the relevant literature.
5. Vito Tanzi and Ludger Schuknecht, "The growth of government and the reform of the state in industrial countries", *IMF Working Paper WP/95/130*, International Monetary Fund, 1995.
6. W Leibfritz, J Thornton and A Bibbee, "Taxation and economic performance", *OECD Working Paper No. 176*, 1997.
7. Eric Engen and Jonathan Skinner, "Taxation and economic growth", *NBER Working Paper No. W5826*, 1996, for example, concluded that a 2.5% point increase in tax-to-GDP ratio reduced GDP growth by 0.2% to 0.3%.
8. HM Treasury, *Budget 2004: Prudence for a Purpose: a Britain of stability and strength*, TSO, HC 301, March 2004. The Treasury provides projections of public sector current receipts (see table C5); the author has made an allowance for those receipts, which are not net taxes and social security contributions.
9. OECD, *Recent tax policy trends and reforms in OECD countries, No. 9*, 2004.
10. OECD, *Economic Outlook, No. 75*, June 2004. The data strictly refer to General Government total tax and non-tax receipts. However, they mirror trends in taxes very closely and most of total receipts are tax receipts (in the UK 94-95%). The author has taken the trends in total receipts as a share of GDP as proxies for trends in tax-to-GDP ratios.
11. OECD, *Economic Outlook, No. 75*, June 2004.
12. Ruth Lea, *The price of the profligate Chancellor: higher taxes to come*, CPS, March 2004.
13. Chris Giles, "Brown yet to grasp thorny problem of corporation tax", *Financial Times*, 21 October 2004, wrote "…a wider problem, according to John Whiting, tax partner at PwC, is that the corporation tax rate no longer seems low by international standards. 'Our 30% rate used to look low, now it looks medium at best', he says."
14. Giles, op cit, also referred to the impact of ECJ rulings that have made the UK's corporation tax regime less attractive. He wrote "already the government has had to impose onerous regulations to stop the tax system being ruled discriminatory." The impact of ECJ rulings is also discussed in (1) Alistair Craig, *EU law and British tax*, CPS, 2003 and (2) Ruth Lea, *The Essential Guide to the European Union*, CPS, May 2004.
15. OECD, *Recent tax policy trends and reforms in OECD countries, No. 9*, 2004.
16. Industrial Development Agency (IDA), "Taxation in Ireland", IDA, Ireland, 2004. Source: www.idaireland.com
17. Ernst and Young, *Ireland: 12.5% Corporate Tax and other tax advantages*, Ernst and Young, November 2002.
18. The rate was 24% in 2000, 20% in 2001 and 16% in 2002 – though there have also been concessionary rates for certain types of approved activities.

19. Finfacts Ireland, "US multinationals profit from tax haven", September 2004. Source: www.finfacts.com
20. "A model of success", *Economist*, 16 October 2004.
21. "The luck of the Irish: a survey of Ireland", *Economist*, 16 October 2004. This survey points out, however, that there are several factors behind Ireland's great economic success, including its sound macroeconomic policy, responsible trade unions, EU subsidies, low personal taxes, demographics and the boost to female participation rates.
22. Gross National Product (GNP) = Gross Domestic Product (GDP) + net investment income. Ireland's net investment income is negative.
23. Charles Robertson, "Flat tax rate", *Directional Economics*, ING Bank, June 2004.

ANNEX

TABLE 1 AVERAGE TOP CORPORATE INCOME TAX RATES (CALCULATIONS BASED ON OECD DATA)

Year	Average top corporate income tax rates
1996	37.6
1997	36.8
1998	35.9
1999	34.8
2000	34.0
2001	32.8
2002	31.4

Source: Chris Edwards, "New data show US has 4th highest corporate tax rate", Cato Institute, April 2002, www.cato.org. Edwards used data from "Corporate tax rate survey", KPMG, January 2002.

TABLE 2 GENERAL GOVERNMENT TOTAL TAX & NON-TAX RECEIPTS (% OF NOMINAL GDP)

Country	1997	2003	2004f	Change between 1997 & 2004f	2005f	Change between 1997 & 2005f
Australia	36.7	37.2	36.7	0	36.7	0
Austria	51.9	49.7	49.2	-2.2	48.3	-3.6
Belgium	49.5	51.6	49.7	**+0.2**	49.3	-0.2
Canada	44.5	41.3	41.3	-3.2	41.2	-3.3
Czech Republic	42.6	43.5	42.2	-0.4	42.2	-0.4
Denmark	58.3	57.3	56.5	-1.8	55.8	-2.5
Finland	55.2	52.7	52.5	-2.7	52.2	-3.0
France	51.8	50.4	50.0	-1.8	49.8	-2.0
Germany	46.6	45.0	44.5	-2.1	44.1	-2.5
Greece	43.7	44.2	44.2	**+0.5**	44.2	**+0.5**
Hungary	44.6	44.2	45.4	**+0.8**	45.3	**+0.7**
Iceland	41.7	46.5	46.6	**+4.3**	46.3	**+4.6**
Ireland	38.6	35.4	35.3	-3.3	35.0	-3.6
Italy	48.4	46.4	45.5	-2.9	45.1	-3.3
Japan	31.3	29.7	29.8	-1.5	30.0	-1.3
Korea	24.5	29.0	29.0	**+4.5**	29.0	**+4.5**
Luxembourg	46.5	46.8	44.8	-1.7	44.5	-2.0
Netherlands	47.1	45.6	44.6	-2.5	44.0	-3.1
New Zealand	43.5	41.6	41.6	-1.9	41.3	-2.2
Norway	55.1	57.4	58.0	**+2.9**	59.1	**+4.0**
Poland	45.3	42.0	40.9	-4.4	40.6	-4.7
Portugal	41.2	45.0	43.2	**+2.0**	43.0	**+1.8**
Slovak Republic	58.8	42.9	40.7	-18.1	39.6	-19.2
Spain	38.6	39.9	39.7	**+1.1**	39.6	**+1.0**
Sweden	61.9	58.7	58.5	-3.4	58.5	-3.4
UK	38.8	39.3	39.8	**+1.0**	40.4	**+1.6**
US	34.2	30.9	30.6	-3.6	31.4	-2.8
Euro area	47.5	46.2	45.6	-2.1	45.2	-2.3
Total OECD	38.9	37.0	36.7	-2.2	36.9	-2.0

f = forecast

Source: OECD, *Economic Outlook, No. 75*, OECD, June 2004.

TABLE 3 CORPORATE INCOME TAX RATES (%): 2000 AND 2003

	2000		2003		% change between
	%	Ranking	%	Ranking	2000 and 2003
Australia	34.0	14=	30.0	=18	-4.0
Austria	34.0	14=	34.0	=9	0
Belgium	40.2	4	34.0	=9	-6.2
Canada	44.6	2	36.6	4	-8.0
Czech Republic	31.0	19	31.0	16	0
Denmark	32.0	18	30.0	=18	-2.0
Finland	29.0	24=	29.0	22	0
France	37.8	7	35.4	5	-2.4
Germany	52.0	1	40.2	2	-11.8
Greece	40.0	5	35.0	=6	-5.0
Hungary	18.0	30	18.0	=28	0
Iceland	30.0	21=	18.0	=28	-12.0
Ireland	24.0	29	12.5	30	-11.5
Italy	37.0	9	34.0	=9	-3.0
Japan	40.9	3	40.9	1	0
Korea	30.8	20	29.7	21	-1.1
Luxembourg	37.5	8	30.4	17	-7.1
Mexico	35.0	11=	34.0	=9	-1.0
Netherlands	35.0	11=	34.5	8	-0.5
New Zealand	33.0	16=	33.0	=13	0
Norway	28.0	26=	28.0	=23	0
Poland	30.0	21=	27.0	25	-3.0
Portugal	35.2	10	33.0	=13	-2.2
Slovak Republic	29.0	24=	25.0	26	-4.0
Spain	35.0	11=	35.0	6	0
Sweden	28.0	26=	28.0	=23	0
Switzerland	24.9	28	24.1	27	-0.8
Turkey	33.0	16=	33.0	=13	0
UK	30.0	21=	30.0	=18	0
US	39.4	6	39.4	3	0
EU-15 average	35.1		31.7		-3.4
OECD average	33.6		30.8		-2.8

Notes:
Combined central & sub-central statutory tax rates (for example, the US's rate is a combination of federal and average state rate).
Rankings indicate the country with the highest tax rate.
Source: OECD, *Recent tax policy trends and reforms in OECD countries, No. 9*, 2004.

PERSPECTIVE

The Perspective series of papers represents a new type of publication from the Centre for Policy Studies. Each Perspective, founded on original research, is intended to provide a brief insight into one particular important issue of the day.

They will therefore compliment our pamphlets – which will continue to focus on the development of long-term policy issues, and our Pointmakers – which will continue to provide in-depth coverage of subjects of topical concern.

Acknowledgements

The Rt Hon Lord Young of Graffham DL has provided generous funding for the Perspective series.

Support towards research for this Study was given by the Institute for Policy Research.

A SUBSCRIPTION TO THE CENTRE FOR POLICY STUDIES

The Centre for Policy Studies runs an Associate Membership Scheme which is available at £100.00 per year (or £90.00 if paid by bankers' order). Associates receive all publications and (when possible) reduced fees for conferences held by the Centre.

For more details, please write or telephone to:

The Secretary
Centre for Policy Studies
57 Tufton Street, London SW1P 3QL
Tel: 020 7222 4488 Fax: 020 7222 4388
mail@cps.org.uk www.cps.org.uk

The aim of the Centre for Policy Studies is to develop and promote policies that provide freedom and encouragement for individuals to pursue the aspirations they have for themselves and their families, within the security and obligations of a stable and law-abiding nation. The views expressed in our publications are, however, the sole responsibility of the authors. Contributions are chosen for their value in informing public debate and should not be taken as representing a corporate view of the CPS or of its Directors. The CPS values its independence and does not carry on activities with the intention of affecting public support for any registered political party or for candidates at election, or to influence voters in a referendum.

© Centre for Policy Studies, November 2004

ISBN 1 903219 83 3

Printed by the Centre for Policy Studies, 57 Tufton Street, London SW1P 3QL