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BRIEFING NOTE

ESTIMATING THE EMPLOYMENT EFFECTS OF LABOUR'S CORPORATION TAX POLICY

1. INTRODUCTION

If the Labour Party wins the General Election, it has pledged to increase the main rate of corporation tax from 20% to 21%. The party has also pledged to keep the corporation tax rate at the lowest rate in the G7.[1] Outside of the UK, the lowest corporation tax rate in the G7 is currently 26.5%. This pledge would therefore allow the party to put in place further increases in the corporation tax rate.

The Coalition Government has cut the main corporation tax rate from 28% to 21%. This rate applies when company profits exceed £1.5 million and will be cut from 21% to 20% in April 2015. This means that the small profits rate which is currently set at 20% will be merged to create a single corporation tax rate. It also means that marginal relief for companies earning profits between £300,000 and £1.5 million can be eliminated.

[1] Labour Press A competitive tax system that supports long-term investment and is fair to all – Ed Balls 2014.

In “The Cost of Labour” published in 2014, we modelled the impact on employment of ten tax policies proposed by the Labour party. In this note, we update that model to estimate the impact on employment of the corporation tax rate rising by one percentage point each year in the next Parliament.

It is assumed that in the event of a Labour victory in May, Parliament passes an emergency Budget and the new rate of corporation tax comes into effect in June. For the remainder of 2015/16, it is therefore assumed that the corporation tax rate is at 21%. The model examines the impact on employment if the rate rises to 22% in 2016/17, then 23% in 2017/18 and finally 24% in 2018/19.

2. GENERAL FRAMEWORK

The model is based on the OBR’s forecasts outlined in its Economic and Fiscal Outlook published alongside the 2014 Budget.

GDP is defined as the sum of Total Domestic Demand and Net Exports alongside the Statistical Discrepancy which is unchanged from the OBR’s forecast outlined in its Economic and Fiscal Outlook published in March 2014. Total Domestic Demand is in turn, the sum of Private Consumption, Private Investment, Government Consumption, Government Investment, Net Acquisition of Valuables and the Change in Inventories.

Government Consumption, Government Investment, Net Acquisition of Valuables and the Change in Inventories are all assumed to be unchanged from the OBR’s forecast. Private Consumption will change as a proportion of the change in household income. Private Investment is modelled as a proportion of the net tax change to business profits.

Exports are assumed to be the same proportion of GDP as in the OBR’s central forecast. Imports are also assumed to be the same proportion of Total Domestic Demand as in the OBR’s forecasts.

The employment effect is calculated by estimating the impact of the taxes on company profits. Profits are used to pay for workers, dividends and investment. The share of profits which goes to pay for workers multiplied by the change in profits is the total change in funds available for workers. After adjusting for wages, the remainder can be divided by the cost of hiring a worker to estimate the reduction in employment as a result of the corporation tax rise.

The estimated total employment effect is the cumulative deviation in total employment from the OBR’s central forecast after the implementation of the higher corporation tax rates.

A permanently higher corporation tax rise may reduce underlying productivity growth and it may also have more intangible effects on entrepreneurialism. However, for the purposes of this model, these longer term effects are not considered.

The note also does not consider the extra administrative costs to the public sector of maintaining the tiered corporation tax rates relative to the unified corporation tax rate under the Coalition’s plans. This note also does not consider the impact of the use of any net tax revenue which is generated.

3. INCREASING CORPORATION TAX

New HMRC data[2] gives an estimate of the revenue which would be generated by a one percentage point increase in the corporation tax rate. It is assumed that Labour would increase only the main rate of corporation tax and not the small profits rate. We therefore adjust these HMRC estimates to reflect this fact. A conservative extrapolation of this data can give an estimate of the revenue raising capacity of higher rates of corporation tax. This extrapolation considers, for example, the diminishing revenue returns of each extra percentage point of corporation tax.

The revenue generated by the corporation tax rises represents the reduction in the profits retained by businesses. This reduction in retained profits leaves businesses with less money to pay for new equipment, to pay shareholders and to hire new staff.

A fall in retained profits from higher corporation tax will therefore have a negative impact on employment, investment and dividends, which then leads to a fall in the level of GDP. Different time lags will apply to each of these channels.

To estimate the share of profits which go to investment, employment costs and dividends, we analysed OBR data from 2009 to 2013. Our analysis suggests that a £1 reduction in profits resulting from the corporation tax rise will lead to:

- Reduced dividend payments of £0.174.
- Reduced employment compensation of £0.312.
- Reduced investment of £0.514.

Businesses react to tax rises gradually; it is therefore assumed that there is a time lag between the tax rise and these reduced payments. The time lags are assumed to be one quarter for dividends, two quarters for wages and three quarters for investment.

The change in total compensation is calculated by multiplying the employment compensation share (0.312) with the tax rise in that quarter. The quarterly tax rise is assumed to rise evenly such that the annual tax rise is the same as that estimated by HMRC. The new compensation is the sum of the existing OBR forecast for total compensation and the change in compensation.

As discussed, after adjusting for wages, this change in compensation can then be divided by the cost of hiring a new worker to derive an estimate of the reduction in employment.

By reducing the funds available for investment and taking on new staff, it is clear that the higher corporation tax rates will hold back business growth and reduce employment growth.

[2] Gov.uk *Direct effects of illustrative tax changes* 2014.

4. UPDATES TO THE MODEL

The model now includes some updates to the model used in "The Cost of Labour" publication. For example, new HMRC data is used instead of OBR data to estimate the revenue implications of the higher corporation tax rates.

The initial publication used the average employment cost as the base to estimate the impact of tax rises on employment. This was sensible given that the programme of tax rises is likely to have a self-reinforcing effect across the economy.

The update, which examines purely the impact of corporation tax, considers that companies paying corporation tax are likely to be bigger, more profitable and have higher costs of employment. The employment effect is therefore likely to be less powerful in the short term than if the tax was more broadly based.

5. RESULTS

It is clear that Labour plans to increase the tax burden significantly should it win the next General Election. Whilst there may be reasons to increase taxes, the party should be open that the consequences for growth and employment will be negative.

The proposal to increase the corporation tax to 21% would go against the trend amongst developed economies to cut corporation taxes. The rising global mobility of businesses and the profits they earn means that higher corporation taxes would drive more corporate activity abroad. Furthermore, instead of guaranteeing that it will not increase corporation tax above 21%, the party has given itself the opportunity to enact much bigger tax rises.

Corporation tax rises, particularly in the context of a programme of tax increases, would add to a negative environment for business. Wealth creating businesses are the driving force of growth, jobs and ultimately prosperity. By contributing to a less welcoming environment for business, corporation tax rises will damage wealth creation and the UK's reputation internationally as a business-friendly country.

Real wages, the deficit and employment growth all ultimately depend on productivity. By cutting the funds available for investment, the tax rises envisaged by Labour would damage productivity growth. Businesses would have less to spend on new technology, innovation and in-work training and the result would be a reduction in the long term growth potential of the economy.

It is also inevitable, that fewer jobs would be created under the Labour proposals. Retained profits are one of the key ways that businesses fund their expansion. Labour's policy means that businesses would have less money available to pay wages to existing and new employees. The result would be that firms would find it more difficult to hire new workers.

In addition, Labour has ignored the benefits of tax simplification which would come from a unified 20% corporation tax rate. The extra complexity which the party wants to maintain seems absurd, especially given the administrative savings to the Treasury that simplification would deliver. Increasing the rate would also add extra compliance costs for businesses which have to spend more time and resources working out their precise tax liability. This is especially burdensome for fast-growing businesses without big compliance departments.

Boosting tax competitiveness is increasingly important to attract and retain successful businesses. The living standards of the British people depend on businesses being able to invest, hire and grow. By raising corporation taxes, Labour would make that more difficult.

Our model estimates that, other things being equal, a rising corporation tax rate would lead to a reduction in total employment of 96,400 by 2018/19 compared to the OBR's estimates of employment under the Government's plans.

Table 1: Forecast results

	2015/16	**2016/17**	**2017/18**	**2018/19**
Main rate of Corporation Tax (%)	21	22	23	24
Cumulative employment cost	1,300	16,100	48,600	96,400

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