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The UK’s lesson for Donald Trump on slashing corporate taxes

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President Donald Trump wants to slash America’s corporate income tax rate, as part of the most ambitious tax reform package since Ronald Reagan’s in 1986. But with little bipartisan support and a Republican party divided over whether to introduce a so-called “border-adjustment tax”, many conservatives are now looking to Britain for inspiration on how a pure corporate tax rate cutting agenda could work.

The US currently has extraordinarily high statutory rates, with a 35 per cent federal rate rising to 39 or 40 per cent once state taxes are considered – way above the average 24.8 percent for OECD countries, or the 19 per cent here. Tech giants and pharmaceuticals companies of course use deductions and exemptions such that they do not pay the full rate, but the World Bank and International Finance Commission estimates that, at 27.9 per cent, the US’s effective tax rate is still second highest in the OECD.

Corporate income taxes are widely believed to be one of the most damaging forms of taxation. Not only are they not transparent, with their burden ultimately falling largely on workers and shareholders, but high profit tax rates can encourage profitable companies to locate overseas for tax purposes, deter new inward investment and discourage incremental investment from existing companies by reducing the expected future return on capital.

Little surprise then that many Republicans in Washington look to London as an example to follow. The Conservative government here has dropped our headline rate from 28 to 19 per cent since 2010, with plans for further cuts to 17 per cent by 2020. Surely Trump should just do what we’ve done?

But the lessons from the UK are perhaps more nuanced than they first appear. In the first few years of the last Parliament, the government prioritised increasing companies headquartering or moving significant operations here by cutting the main rate. But they offset the loss of revenue by making capital depreciation and investment allowances less generous, broadening the tax base.

While this did make the UK a more attractive place to locate for profitable companies, the less generous allowances actually raised the marginal tax rate on an incremental break even investment from 20 to 22 per cent, acting as a disincentive for companies here. It’s only since 2012 that the government has focused solely on cutting the statutory rate, with the marginal rate for a break-even project falling to 17 per cent (significantly below the US’s 23 per cent).

Over the whole period, the reforms have equated to a very significant net tax cut. The UK now has the joint fifth lowest statutory rate in the OECD but, given continued stingy capital allowances, an effective marginal rate that is falling, but somewhat closer to the middle of the pack. Official estimates suggest the reforms have “cost” over £12bn in lost revenues on a static basis, including clamp downs on tax avoidance, though HMRC estimated that 45 per cent to 65 per cent of this would be recouped over two decades due to more investment and higher GDP.

Though the Labour Party repeats the static cost in its quest to reverse the tax cuts, there is some evidence that corporate revenues are already exceeding expectations. In 2013, the government projected revenues would fall to £38.2bn by 2016/17 as rates tumbled. In fact, they touched £50bn. This should not surprise us. Corporation tax revenues have fluctuated cyclically between 1.7 per cent and 3.5 per cent of GDP since 1980 when the rate was 52 per cent. They are currently at 2.6 per cent of GDP –the same rate as seen in 1985 when the main rate of tax was 40 per cent, and the Thatcher boom was well underway.

The government appears to have been somewhat successful too in its aim to attract businesses to locate here. Fiat, Snapchat, McDonald’s, Starbucks and Ineos are just a handful of the companies which have moved major headquarters or significant parts of their operation to the UK in recent years. To remain open post-Brexit, and with international coordination putting pressure on the lowest tax jurisdictions, the UK seems likely to continue this charm offensive.

What then is the key lesson for Trump from the UK experience in slashing corporate taxes? The main one is surely not to worry much about revenue neutrality, but to focus on the economics. There is good theoretical and empirical evidence to suggest cutting corporate tax rates is good for the economy. But if in the name of doing so you seek to “pay for” this with damaging base-broadening measures which raise effective tax rates, then you will nullify the positive investment effects.

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