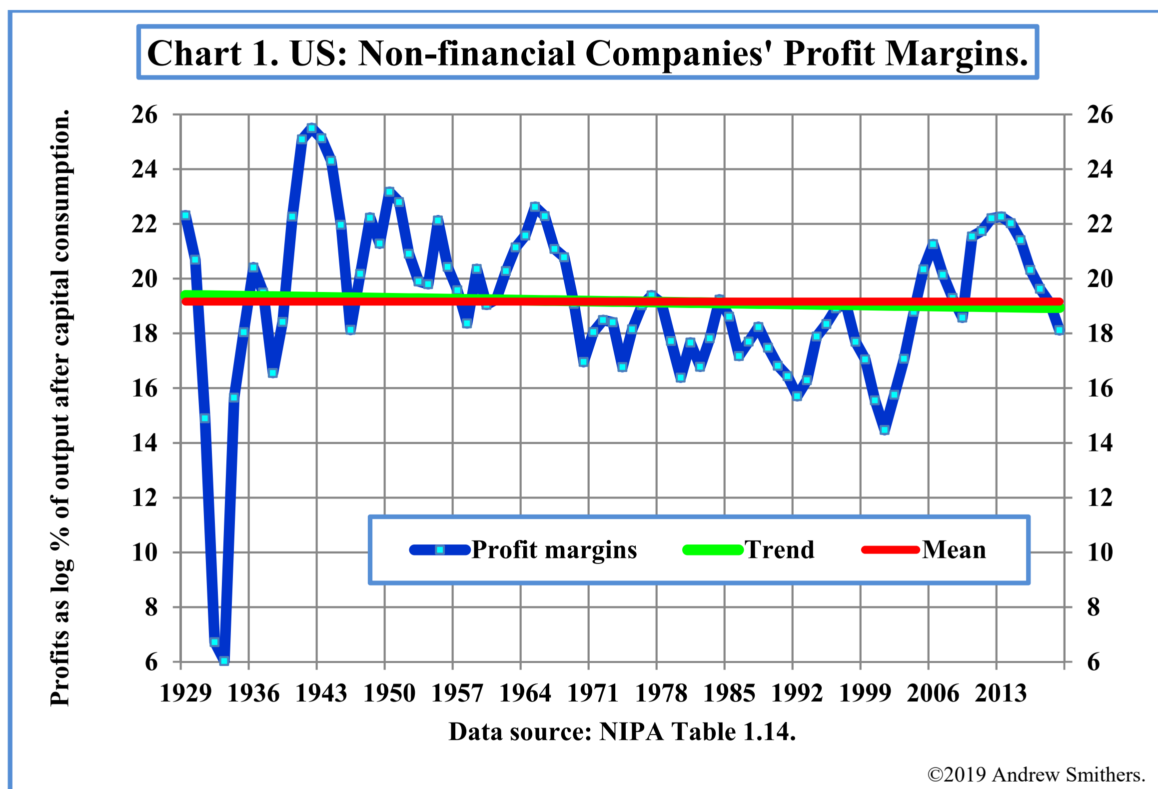
Corporation Tax.

Corporation tax is widely and mistakenly seen as a tax on shareholders, which it is not, rather than a tax on investment, which it is. Understanding this issue is vital if we are to have sensible economic policies in the UK and US.

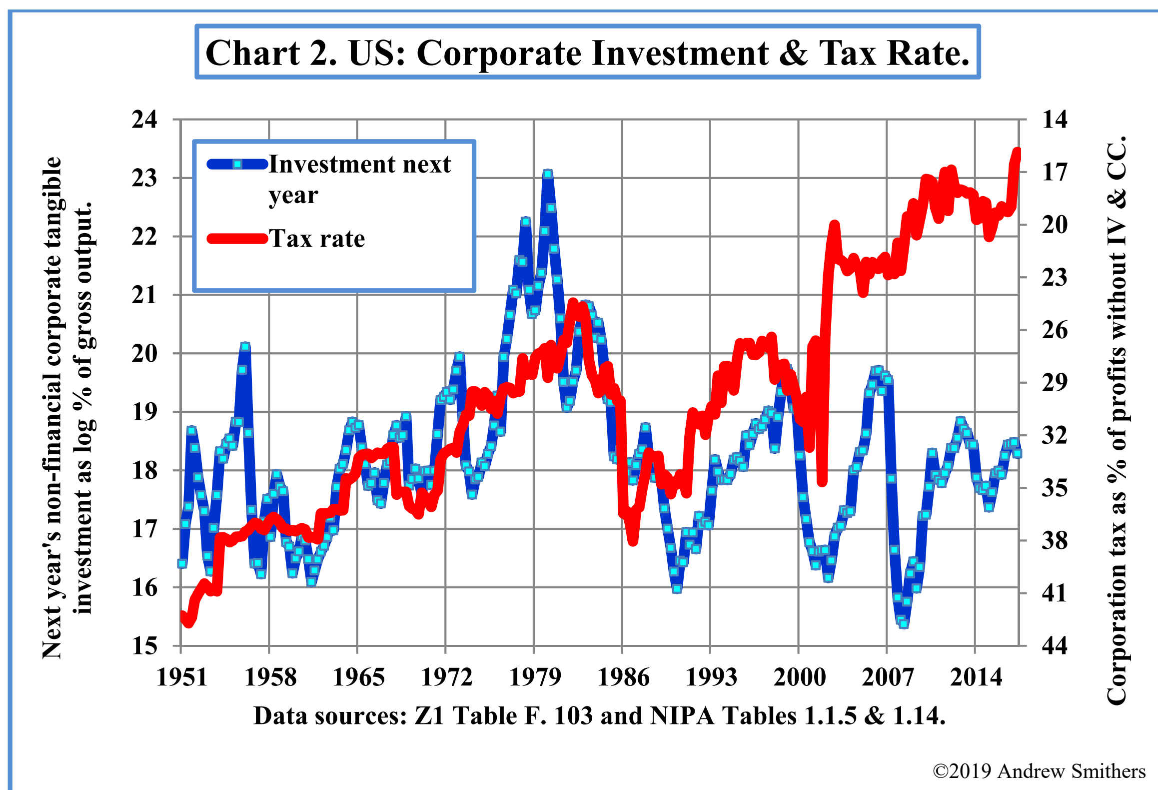
Because UK statistics are so poor, with the necessary long-term data being unavailable, it is necessary to use those of the US to make this clear. We have data for the real returns to shareholders covering the past 217 years and they show that these have averaged 6.4% p.a. and been strongly mean reverting. For the first 115 years there was no corporation tax, as the Supreme Court had ruled that it was unconstitutional and the necessary revision was only passed in 1916 under the threat of war. Since then the effective rate, which through allowances differs from the headline figure, rose to 57% in 1943 and is now down to 13%. For more than half of the period for which we have data there was no corporation tax, and returns to shareholders were the same as those since 1916 when profits were subject to it. In addition there has been no apparent connection between the swings in returns and those in the tax rate.



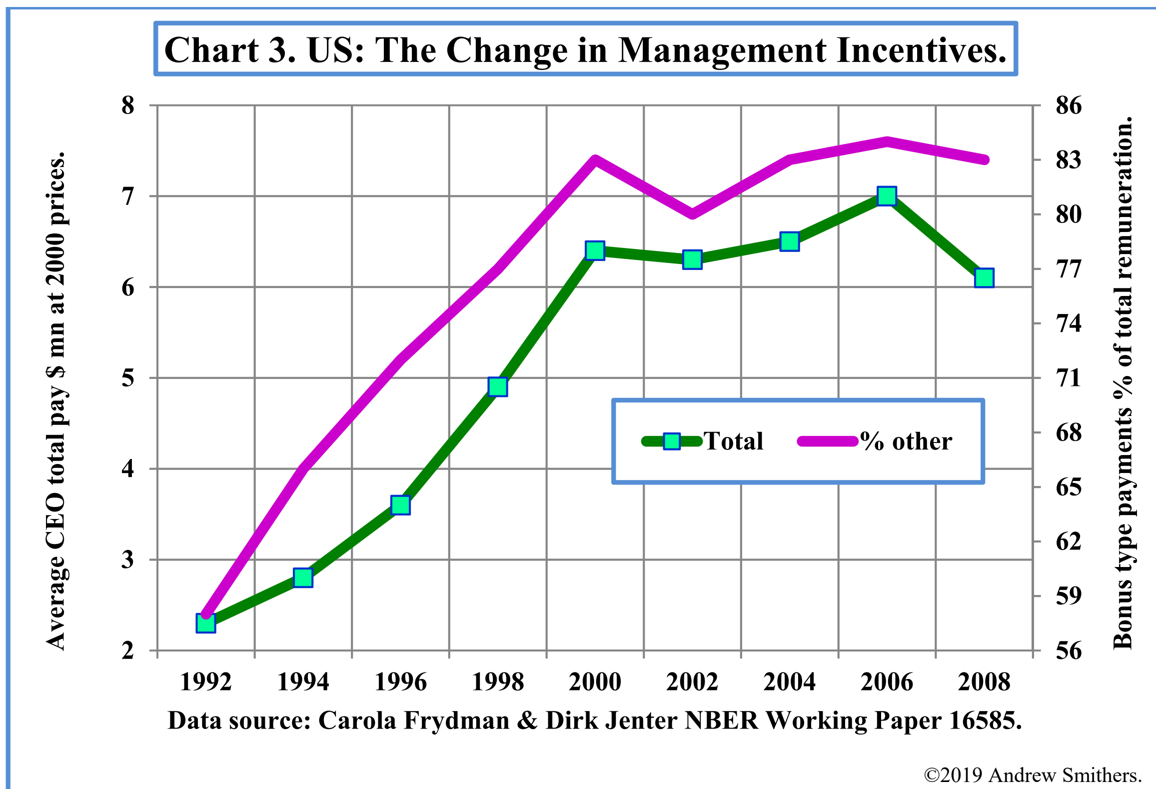
It is clear therefore that shareholders don't pay the tax, so the question is who does and there are three candidates, workers, consumption and investment. We have data since 1929 on the shares of corporate output going to labour or profit and these, as Chart 1 shows, are also strongly mean reverting. I show the proportion of output going

to profits, all the rest goes to pay employees. The near identity of the average with its trend shows that the shares of output going to labour and profits are mean reverting and thus stable over time. Companies cannot therefore be passing the cost of corporation tax either on to labour or consumers, since profit margins and the share of profits are stable.

As neither employees nor shareholders pay corporation tax and the money is raised it must be a tax on something and the answer must be investment. The return on new investment will fall if corporation tax rises unless the return before tax rises and, as the return doesn't fall, it must rise before tax. At any time the returns on new investment will vary and only those that are expected to give sufficient returns will be made. There will be fewer of these when corporation tax rises and so there will be less investment than there would be if the tax rate had not changed.



Corporation tax is not, however, the only thing that influences investment and its level does not necessarily adjust immediately to changes in the tax rate. In the US the change used to be quick but has not worked since 2000, as Chart 2 shows. Until then the level of investment in the following year was significantly correlated with the effective rate of corporation tax ($R^2 = 0.41$) but not since ($R^2 = 0.19$).



The relationship has changed because investment this century has been discouraged by the arrival of the bonus culture in the 1990s when, as Chart 3 shows, there was a dramatic change in the amounts and methods by which corporate management is remunerated.[1] The impact of today's payments' system is to increase the risks to companies that come from underinvesting by increasing the immediate rewards to management from not doing so. As unquoted companies, including foreign owned subsidiaries, are barely affected by this economically perverse incentive, the effect is likely to die away as shareholders have already begun to notice the decreasing importance of quoted companies.

It would of course be sensible to speed up this process as it is the cause of the poor growth in productivity we have seen in both the UK and the US this century. So long as the current system lasts, however, cuts in corporation tax will, as we have already seen, fail to stimulate investment and the damage that will be done should they rise in the UK will probably take some years to be apparent. We risk repeating the damage that Gordon Brown did when he abolished advanced corporation tax and thereby effectively doubled the rate. The failure of the financial press to understand this meant that far from being pilloried for the damage he was doing he was praised for his

[1] For a more detailed explanation see "Productivity and the Bonus Culture" by Andrew Smithers published by Oxford University Press 2019 and in "The NTV Model for Total Factor Productivity" by Andrew Smithers published in World Economics Vol 20 No 2 April-June 2019.

non-existent fiscal probity. All he really did was to raise current taxes on investment and savings, thus reducing future growth and future tax revenue.

By failing to invest British business has made itself vulnerable to an increase in corporation tax and to finding that it will be some years before the damage that such an increase will produce will be apparent.

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