

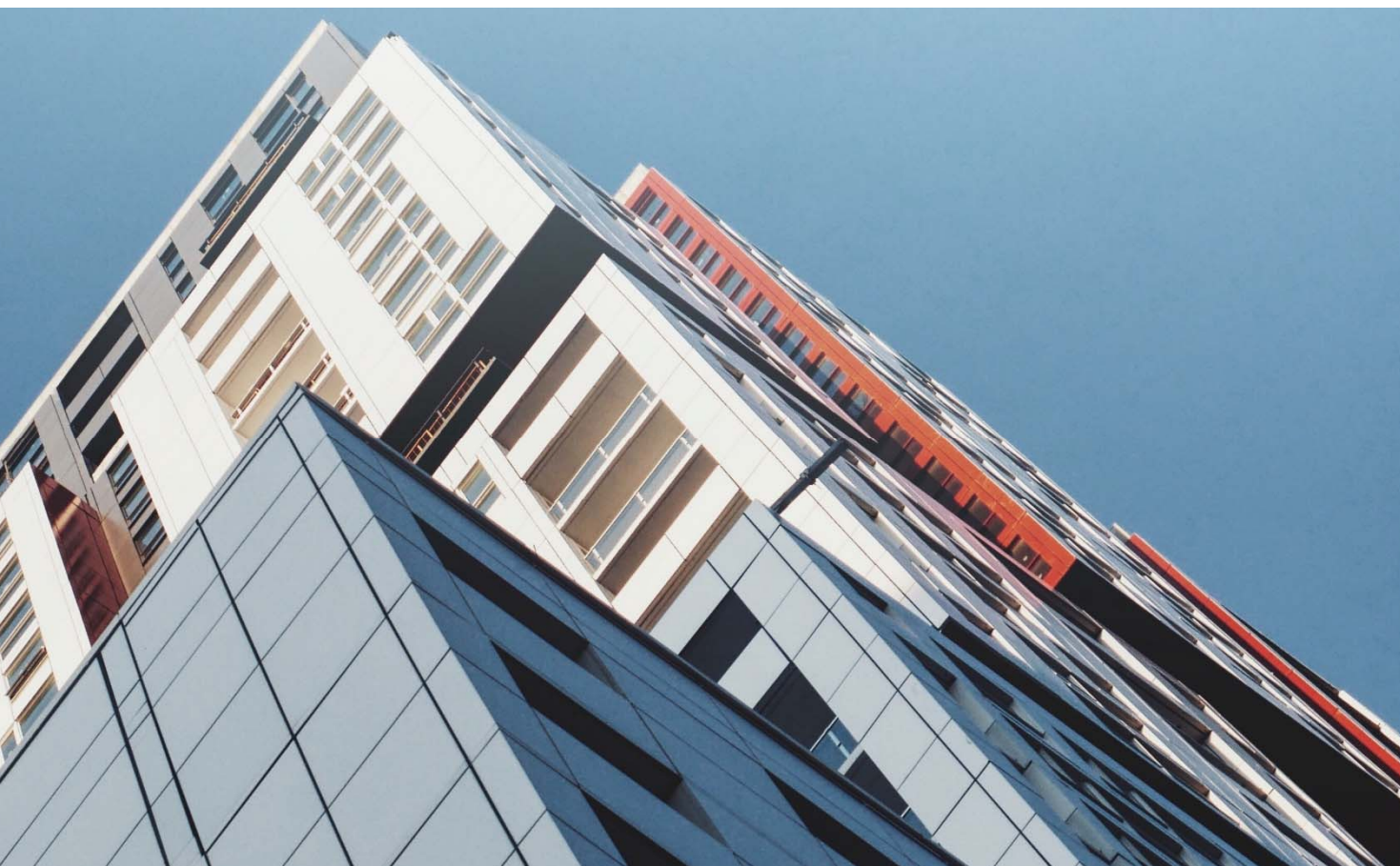


Corporate Tax in the UK

The Triumph of 'Austerity' Over Evidence

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ABOUT US

Austerity and its Alternatives is an international knowledge mobilization project committed to expanding discussions on alternatives to fiscal consolidation and complimentary policies among policy communities and the public. To learn more about our project, please visit www.altausterity.mcmaster.ca.

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Abstract

The continuation of 'austerity' policies, long after the evidence has demonstrated their nature as both self-defeating and regressive, represents a triumph of ideology over evidence – and a collective failure of the wider political processes that should have ensured evidenced influenced policy. Included within that failure are the public communication efforts of researchers responsible for that evidence. In the UK, austerity has exhibited a peculiarly tax-averse character, resulting in even greater cuts to services. The UK's corporate tax cuts also provide perhaps *the* paradigmatic example of austerity policy pursued in the face of a government's own evidence. As 2016's political events in OECD countries have increasingly laid bare, evidence alone offers no guarantee of better policy. The challenge for researchers is as much one of communication. In that spirit, a Fiscal Irresponsibility Index is proposed, to rank governments according to the damage associated with their pursuit of 'austerity'.

PRELIMINARY DRAFT: NOT FOR CITATION OR QUOTATION



Austerity: The Consensus Against

The economic claims of the policies that have come to be known as 'austerity' are few, powerful, and specific. First, expansionary fiscal contractions (EFCs) are possible. Second, EFCs are desirable in high-debt situations such as those that followed the global financial crisis, because debt ratios are a (negative) determinant of economic growth rates.

David Cobham (2016) provides an overview of the argument and evidence for each claim, and we summarise this here. In contrast to the Keynesian view that public spending cuts and tax rises will directly reduce aggregate demand and (via the multiplier), income, the EFC argument holds that there can be indirect positive effects on expectations, leading to increases in investment and so to growth. Meanwhile, 'Ricardian Equivalence' would imply public understanding that tax rises will be followed by tax cuts, thereby averting reductions in consumption and so dispensing with the direct part of the fall in aggregate demand. In addition, cuts in public spending may free up resources for (more productive) private economic activity; and falls in interest rates will 'crowd in' private investment to offset in part the immediate negative effect on income of fiscal consolidation.

For various reasons, these propositions may be expected not to hold during severe recessions such as provoked by the GFC. In practice however, the argument has been fought on empirical rather than theoretical grounds. A range of influential papers from Alesina and co-authors shifted from a claim that EFCs based on spending cuts might be less damaging or more beneficial than those based on tax increases, to the outright claim the former tended to be followed by sustained growth and deficit reduction.

But subsequent reanalysis of the mutual causality between budgets and growth has seen a compelling consensus view emerge, against the likelihood of EFCs: from the IMF's (2010) *mea culpa* and Perotti's (2011) reversal of the positions associated with Alesina and Perotti (1995), to the econometric and sample advances of Jorda and Taylor (2013), who ultimately demonstrate that fiscal contractions are indeed, contractionary (and much more so when the starting point is an economic downturn). They use their findings to perform a counterfactual simulation for the UK, showing that more than half of the shortfall between the leading forecast in 2010, and the actual outturn in 2013, could be attributed to 'austerity'. Finally, Taylor's (2015) discussion of Alesina et al. (2015) concludes that even the latter have also – albeit implicitly – joined the consensus.

The prominence of the second claim, that public debt ratios above a certain point inhibit growth, is largely due to the findings of Reinhart and Rogoff (2010, 2012). In addition to the errors uncovered by Herndon et al. (2014), the more comprehensive analysis of Pescatori et al. (2013) is unable to identify any such ratio



turning point. As Cobham (2016) argues, the range of historical factors in the dataset – such as post-WWII recovery – mean that “the simple question raised by [Reinhart and Rogoff] was too simple to be genuinely fruitful, even without spreadsheet errors” (p.34).

Overall, Cobham (2016, p.34) concludes that: “there is a serious question as to why politicians have often insisted on austerity... [T]he immediate conclusion is that the fiscal austerity imposed in so many countries has no serious intellectual justification.” Wren-Lewis (2016) goes further, arguing that: “austerity was the result of right-wing opportunism, exploiting instinctive popular concern about rising government debt in order to reduce the size of the state. This opportunism, and the fact that it was successful (in its own terms), reflects a failure to follow both economic theory and evidence.”

The willingness – or perhaps the deliberate desire – to follow policy in the absence of any credible, intellectual justification is, if anything, more stark when it comes to the tax policies pursued.

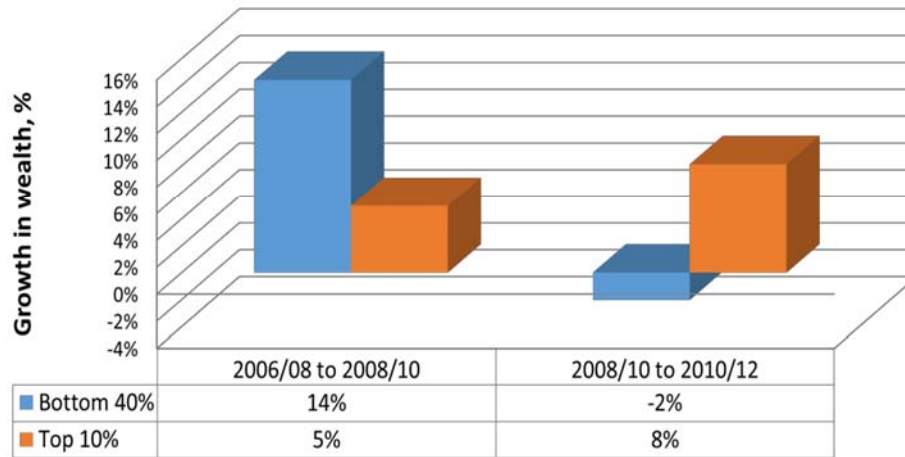
The UK’s Peculiarly Tax-Averse Austerity

Overall, UK austerity has performed in line with the consensus view. The national debt has risen sharply, and growth has been anaemic. Wren-Lewis (2016) estimates a loss of around 4.5% of GDP (in level terms).

The immediate costs of financial crises can often be relatively progressively distributed, since it is higher-income households that tend predominantly to hold the assets of which prices are hit. The GFC has not proved an exception. In the UK, wealth inequality initially fell substantially. The assets of the bottom four household deciles rose more than that of the top decile from 2006/8 to 2008/10; but then fell during 2008/10 to 2010/12, while that of the top decile rose more sharply.



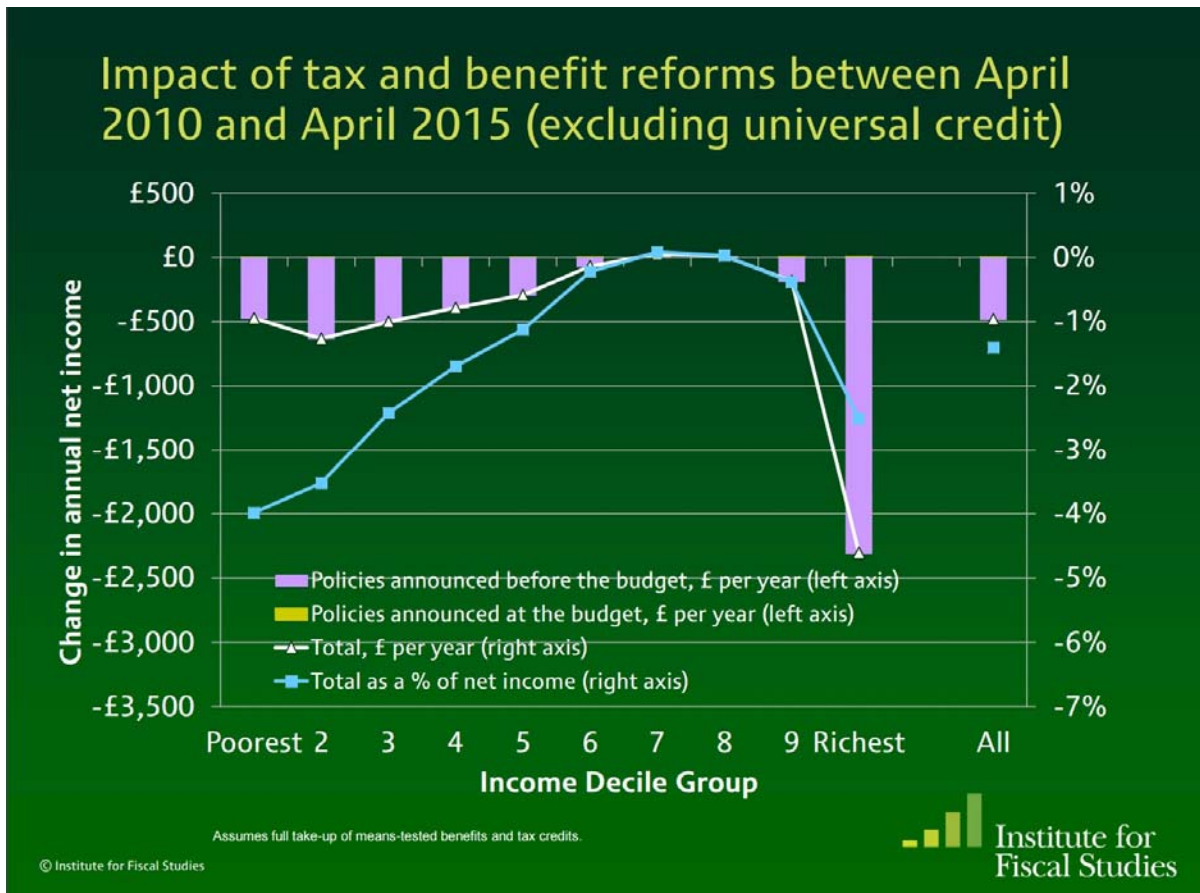
Changes in total household wealth during the crisis



Source: data from Household Wealth Surveys, National Statistics, UK.

The inappropriateness of the Gini coefficient, especially for high inequality situations, is made clear by the fact that this data gives rise to a near-flat Gini of 0.60. The Palma ratio (the ratio of shares of the top decile to the bottom four deciles – see Cobham, Schlogl and Sumner, 2016) shows an initial sharp fall, followed by an even sharper rise – so that even by 2010/12, wealth inequality was higher than the period immediately preceding the crisis.

The 2010-2015 coalition government was happy to claim success in controlling vertical inequality, despite the underlying problems with both the claim and with inequality. Yet the direction taken was quite different. Fiscal policy measures consistently penalised lower income households, as the Institute of Fiscal Studies showed repeatedly, in response to repeated budgets deepening the effects.



Source: Joyce, 2015. Note that the top income level changes relate almost entirely to measures announced before the 2010 election by the then-Labour government.

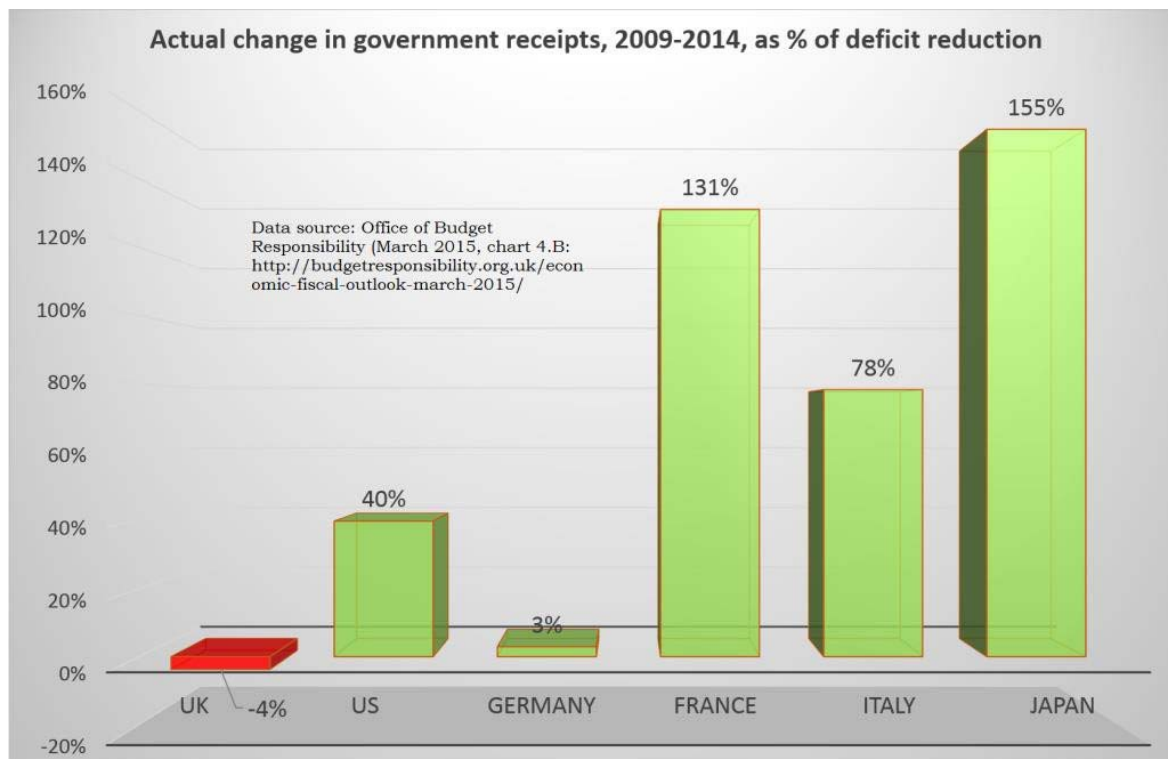
As well as immediate distributional impacts being negative, the direct and indirect impact of cuts driven by austerity resulted in particular groups bearing a disproportionately heavy burden. Duffy (2015) evaluated the impact of cuts in services, and found the following: that people living in (income) poverty made up 21% of the UK population, but bore 39% of the cuts; and that people living with a disability made up 8% of the population, but bore 29% of the cuts. Perhaps the most extreme impacts have been imposed on people living with the most severe disabilities, who made up just 2% of the population, but bore 15% of the cuts – in other words, more than seven times the burden of the rest of the country. Other analyses (e.g. Annesley, 2014) show disproportionate burdens falling also on women.

Unsurprisingly, although thus far with little apparent impact, this approach has been widely condemned. This year, the UN Committee on Economic, Social



and Cultural Rights realised a highly critical report (UNCESCR, 2016) which reminded the UK of its duties towards progressive achievement of rights, recommending a review in light of the fact that austerity measures “must be temporary, necessary, proportionate and not discriminatory, must not disproportionately affect the rights of disadvantaged and marginalized individuals and groups and respect the core content of rights”. On tax, they called on the UK “to conduct a human rights impact assessment, with broad public participation, of the recent changes introduced to its fiscal policy, including an analysis of the distributional consequences and the tax burden of different income sectors and marginalized and disadvantaged groups [and to] ensure that its fiscal policy is adequate, progressive and socially equitable and improves tax collection so as to increase resources available for implementing economic, social and cultural rights”.

Underpinning the especially harsh distributional impact of austerity is a particular feature which appears to have been peculiar to the UK. While other countries pursued a combination of tax rises and public spending cuts, the UK was apparently alone in cutting taxes – so that spending cuts were even larger than the intended reduction in the deficit.





Source: <http://uncounted.org/2015/03/20/the-uks-tax-averse-austerity/>.

The government's independent watchdog, the Office of Budget Responsibility, reached a damning conclusion (OBR, 2015):

"[T]he UK began the period with the second highest deficit (after the US) and ended with the second highest (after Japan), despite the second largest fall among these countries.

The contribution of lower spending to that fall was the largest among these countries. The UK was the only country where the deficit has not been reduced by having revenue grow faster than national income. That revenue weakness has come despite employment growth in the UK over the past five years having been the fastest among these countries. It largely reflects weaknesses in income taxes, due to policy measures and disappointing productivity and earnings growth."

In a world in which the earlier findings of Alesina and co-authors had withstood scrutiny, the UK's extreme tax-averse austerity might perhaps have found some intellectual backing – but as we have seen, this was not the case. While the consensus may have been somewhat less than comprehensive in 2010, it quickly solidified over the following few years, with no appreciable effect on the depth or direction of the UK austerity stance. Successive UK governments have, in effect, imposed both greater damage to the country's growth performance, and greater hardship above all to its poorer and more vulnerable citizens, *in the face of the evidence* that this would be, and became, the demonstrable outcome.

UK Corporate Tax: Paradigmatic Triumph over Evidence

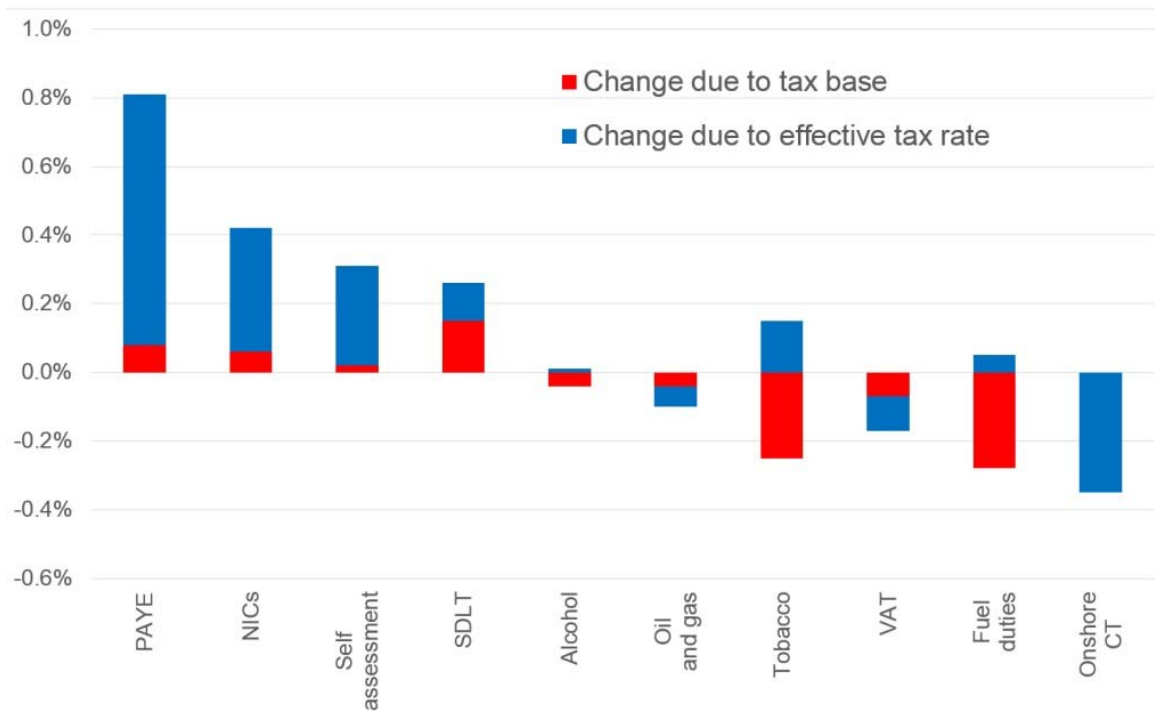
The UK's policies in respect of corporate income tax offer an especially clear case of the pursuit of policies for what can only be ideological reasons – since the contemporaneously available evidence of both the government's own analysis, and that of the Office for Budget Responsibility (OBR), was clear cut.

In 2015, the government set the terms for further austerity budgets for the coming five-year parliament. One notable difference to the preceding period was



the intention to make tax rises a (small) part of the continuing fiscal consolidation. The OBR forecast a total growth in tax revenue of 0.9% of GDP. This growth was to be more than completely accounted for by increases in the effective rates of income tax and national insurance contribution (NICs) – partially offset by cuts to VAT and especially to corporate tax, along with forecast reductions from reduced fuel and tobacco use.

Sources of changes in the tax-to-GDP ratio (2014/15 - 2020/21), per OBR



Strikingly, at least for believers in the Laffer curve, the OBR forecast no increase in the *base* for corporate income taxes. In other words, all of the cuts proclaimed to make the UK the most 'competitive' economy in the G20, taking the headline rate down to 18% by 2020, were forecast to produce an increase in profitable UK activity of precisely zero.

The government's own forecast also made the case against. HM Revenue and Customs' analysis (HMRC, 2015) identified annual revenue losses reaching £2.5 billion by the end of the parliament, on top of the £7.5 billion in annual losses from the previous parliament's cuts. The claimed impacts include making the UK more attractive as an investment location, but the costing – the £2.5 billion of



annual losses – *includes* the expected behavioural change of greater profit-shifting into the UK.

The UK's government under the new leadership of Theresa May has just announced a reversal of its previous decision to suspend further cuts in corporate income tax. At the same time, the previously forecast increases in personal income taxes have now been comprehensively downgraded. As of the Autumn Statement of November 2016, the OBR is forecasting a £90 billion shortfall over 2016-17 to 2020-21, compared to its pre-Brexit referendum analysis in March 2016.

By the end of the period, up to half of that loss reflects changes in expectations about the economy, including major falls due to lower expected average earnings. The remainder, which is the majority in the earlier years at least, largely reflects lower tax receipts and higher rates of incorporation. A widely predicted effect of widening the wedge between personal and corporate income has been that higher earners are increasingly taking advantage of the possibility of incorporation. This has somewhat supported corporate tax receipts, even as effective rates for multinationals have tumbled; but seems likely to continue being more than outweighed by losses in personal income tax and NI receipts. It may also change the political dynamics around the personal income tax, as more high earners opt out.

Conclusions: Policy Research and/or Policy Influence?

In the UK at least, the evidence is abundantly clear that austerity policies have:

- Failed on their own terms to address the post-GFC debt position;
- Reduced economic growth substantially; and
- Significantly exacerbated inequalities in multiple dimensions.

The decision to pursue a particularly extreme austerity, in which spending cuts exceeded intended deficit reductions so that taxes could be cut rather than rise, seems likely to have worsened those impacts – in particular, as regards the distribution.



The decision to pursue ongoing reductions in the corporate tax rate provides perhaps the paradigmatic example to willingness to disregard even the government's own evidence, for what can then only be seen as an ideological preference – including for the ex ante predictable distributive impact.

There are multiple reasons why the research consensus has not had greater policy influence – arguably, has had no noticeable influence at all. Simon Wren-Lewis (e.g. 2015) has discussed a range of issues around the role of the media, and these are non-trivial. But it is also the case that researchers have not done their work justice, in the public communication of the policy relevance of their findings.

One obvious reason seems likely to be the desire to remain 'apolitical': to be seen as producing technically sound, ideologically neutral contributions to the debate, in order to be taken seriously as academics. I put 'apolitical' in scare quotes because this claim is simply inconsistent with the actual policy context. The decision effectively to downplay findings which may be uncomfortable for policymakers, through either their non-communication or their poor communication, is itself a political act. And it is one that makes the introduction or continuation of demonstrably bad policies more likely.

It's traditional at this point to close by highlighting the need for further research, to confirm or extend existing findings and to inform future policy. There is certainly an agenda here, including to monitor and to evaluate the ongoing damage of flawed policies. But by far the greater issue is not the absence of research but the absence of its political influence. The policy research agenda must therefore be heavily focused on influence.

The opportunity for evidence-led advocacy around austerity is wide open. In the area of corporate tax, for example, there are a range of measures claiming to reflect and/or encourage the economically illiterate concept of tax competition. In many cases, including shamefully the World Bank/PwC Paying Tax measure, countries would outperform simply by abolishing all corporate taxation and regulation. Without opposing and research-based policy pressure, these efforts inevitably sway governments and the public.

As an example, the Financial Secrecy Index, first published by the Tax Justice Network in 2009, has created a valuable space in media, advocacy and research (see Cobham et al., 2015). The index has become, in effect, the global ranking of tax havens – while at the same time establishing in popular and policy thinking the preferred concept of secrecy jurisdictions, as responsible for the bulk of illicit financial flows and cross-border tax abuse. There are various efforts underway to establish measures relating specifically to fair taxation (e.g. the Plato Index: Cobham, FitzGerald & Janský, forthcoming) and to corporate tax havenry (a Tax Justice Network project will deliver this in 2018).

A clear space exists for a measure that would rank countries more widely according to their pursuit of austerity. Given the importance of the title in setting the



desired narrative, one suggestion would be for researchers to design a Fiscal Irresponsibility Index, which would put the focus each year on those governments that have most egregiously ignored the academic consensus, and so most badly failed to deliver progressively shared economic progress. An alternative approach would be to include the word 'austerity' in the title. While this raises the likelihood of immediate public identification, it risks reinforcing the unhelpful narrative that national finances are equivalent to those of an overspent household. Framing matters.

The questions for researchers are less of the form, 'What is the gap in policymakers' knowledge that, once filled, will lead to improved outcomes?' Rather, they are of the form, 'What is the gap in research communication that, once filled, will lead to improved outcomes?' That means communicating to policymakers, but also communicating to those who influence policymakers – above all, the media and the wider public. That, in turn, means allowing the communication imperative to influence the choice of research. While this may be anathema to some, it is again the case that deciding not to do this is not apolitical, but an active choice that will make bad policy decisions more likely.



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