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Corporation Tax Risks to the Public Finances

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Between 2014 and 2020, corporation tax (CT) revenue increased by 156 per cent, from just over €4.6 billion to €11.8 billion in 2020. This growth rate far outstripped that of other tax headings with the result that the proportion of overall revenue accounted for by CT has risen sharply: in 2020 CT contributed one euro in every five of all Exchequer tax revenue, up from around one in ten in 2014. The public finances have benefitted from the receipt of these record inflows of CT, but there have been long-standing concerns over the reliability and sustainability of revenue from this tax heading.[1]

Recent Corporation Tax Developments

The exceptional growth in CT revenue since 2015 has been well in excess of the rate of growth in underlying economic activity in Ireland as measured by various indicators. From 2015-2019, modified gross national income (GNI*) in nominal terms is estimated to have grown at an average annual rate of 7½ per cent.[2] In contrast corporation tax revenue increased by an average of around 20 per cent per year over the same period. Accordingly it is worth examining what the increase in CT would have been had revenue grown broadly in line with underlying national income (GNI*).[3] The difference between this and the actual corporation tax outturn can be considered an approximate measure of windfall revenues.

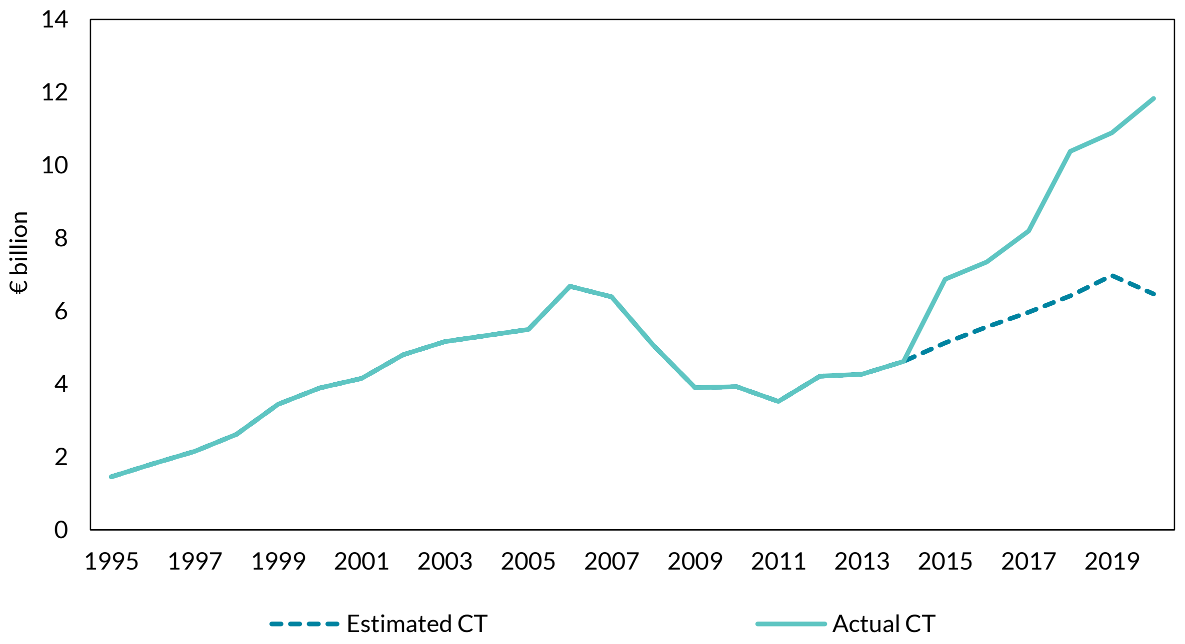
[1] See Central Bank of Ireland (2020) https://www.centralbank.ie/docs/default-source/publications/quarterly-bulletins/boxes/qb1-2020/box-d-developments-in-corporation-tax---an-update.pdf and IFAC (2016) https://www.fiscalcouncil.ie/wp-content/uploads/2015/03/AN-10-Challenges-Forecasting-Irish-Corporation-Tax-Final-Web.pdf

[2] Modified Gross National Income (GNI*) is an adjusted measure of national income that strips out the effects of certain multinational activity that does not impact the incomes or employment of Irish residents.

[3] This differs from a forecasting exercise where the objective is to estimate a model which can predict as closely as possible the actual level of corporation tax.

Figure 1 compares actual CT receipts since 2015 to an estimate of CT revenue from a simple equation that relates changes in GNI* to changes in CT revenue.[4] The results suggest that, given the historical relationship between CT and GNI*, overall CT revenue was €5¼ billion higher at the end of 2020 than would have been expected given the realised growth in modified national income. This figure is close to IFAC's "central" estimate of excess CT revenue in 2020 of €4.8 billion.[5]

Figure 1: Actual and Estimated Corporation Tax Revenue, € billion

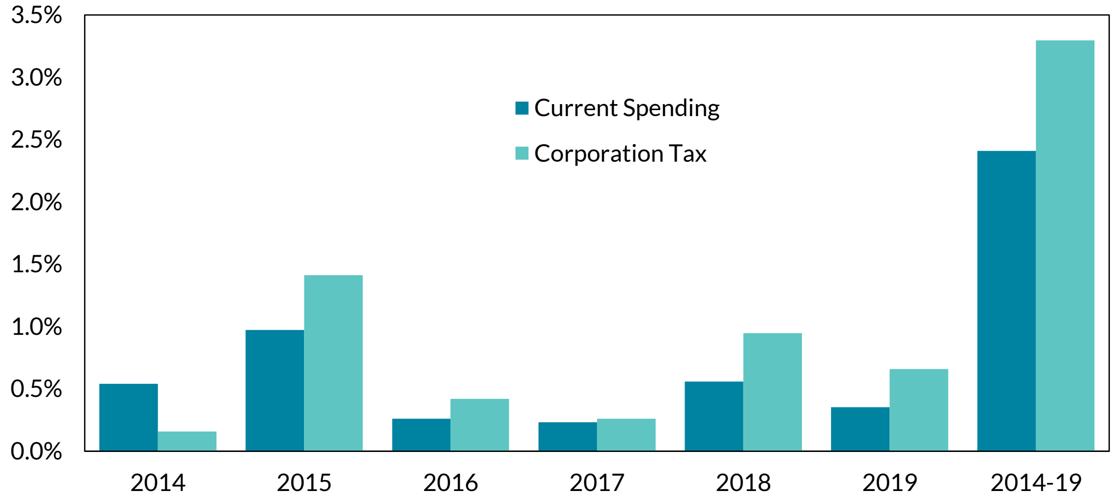


Source: CSO, Department of Finance and own calculations.
Note: Estimated is from an equation that uses changes in nominal GNI* to explain changes in CT revenue.

The annual corporation tax take has consistently outperformed the Department of Finance's Budget day forecasts. Between 2014 and 2020, actual revenue has exceeded the forecast by an average of €1.2 billion per annum. At the same time, government current spending in the years up to 2019 also exceeded budget targets on a consistent basis (Figure 2). With some unexpected CT revenue used to fund day-to-day spending increases, the risk to the public finances from a loss of CT is greater than if a larger proportion of the unexpected CT revenues of recent years had been saved by reducing debt or enhanced contributions to a rainy day fund.

[4] Equation: dlog(CT) = c(1) + c(2) * dlog(GNI*). Sample: 1995-2014.
[5] See https://www.fiscalcouncil.ie/wp-content/uploads/2021/05/FAR-May-2021-S10-Corporation-tax-analysis.pdf

Figure 2: Corporation Tax and Gross Voted Current Spending v Profile (% GNI*)



Source: Department of Finance.
Note: Chart compares the budget day forecast for Exchequer current spending and corporation tax revenue to the actual outturn for each year, expressed as a proportion of nominal GNI*.

Risks to Ireland from Proposals on International Tax Reform

As part of the OECD's Base Erosion and Profit Shifting (BEPS) process, negotiations have been ongoing for several years aimed at reforming the rules on the taxation of multinational companies and improving the transparency and coherence of the international tax environment. The first round of the BEPS process culminated in the publication of 15 actions for tax authorities and governments. The aim of the actions agreed from the first round was to ensure that profits are taxed where the economic activity generating the profits takes place and where added value is produced.[6] The first measures were implemented in 2016 and resulted in some multi-national enterprises (MNEs) shifting Intellectual Property (IP) assets from no-tax countries to low-tax jurisdictions where substantial business activity was taking place. Ireland benefitted from these actions as MNEs moved their IP assets to Ireland and additional taxes were collected. Data published by the Revenue Commissioners show that corporation tax payments by companies claiming intangible capital allowances amounted to €5.6 billion in 2020, just under half of all CT payments and 50 per cent higher than the equivalent amount collected in 2019.[7]

The second round of the BEPS (BEPS 2.0) process is focussed on two pillars:

1. **Pillar one** aims to change profit allocation rules so that more of the profits of multinational firms would be allocated to locations where sales or users are located rather than where the

[6] See https://www.oecd.org/tax/beps/about/
[7] See https://www.revenue.ie/en/corporate/documents/research/ct-analysis-2021.pdf

goods or services are produced. The allocation of the tax base to market jurisdictions would be based on a formula agreed at the BEPS talks.

2. **Pillar two** envisages the introduction of a global minimum effective tax rate. The introduction of a minimum tax rate on a country-by-country basis would represent a significant change to the international tax system. It would give governments the right to tax profits currently being taxed below the minimum rate.

Negotiations on both pillars of BEPS 2.0 were delayed in 2020 due to the COVID-19 pandemic but the talks have recently gathered considerable momentum, reflecting a number of international developments. Under the new Biden administration, US engagement with the BEPS process has intensified.

Negotiations were given further impetus following agreement reached at a meeting of G7 countries in London on 5 June. At the meeting, the G7 agreed to support the reforms proposed under both pillars of the BEPS process. In particular, the G7 committed to a reallocation of taxing rights to market countries (Pillar 1). Given the small size of Ireland's domestic market, if this proposal is implemented it would reduce the amount of profits taxable in Ireland at 12.5 per cent and, therefore, would lead to lower corporation tax revenues. Notably, it appears that the G7 agreement calls for the reallocation of taxing rights to market countries to apply to a set of all large companies and not to digital companies only, as had been initially proposed by the OECD.[8] This could further increase the loss of revenue from this change. As noted by Coffey (2021), Ireland was the third largest recipient worldwide of corporation tax revenue from US MNEs in 2018. These firms accounted for around 60 per cent of overall CT receipts.[9] A change in the tax system whereby more tax is applied based on the location of the firms' sales and not on its physical location as at present poses clear risks to Ireland's CT receipts.

Moreover, the G7 recently committed to the introduction of a global minimum tax rate of at least 15 per cent on a country-by-country basis. If implemented, this would reduce the attractiveness of Ireland's 12.5 per cent corporation tax regime. In calculating their tax liabilities, MNEs would no longer be able to blend taxes paid in high-tax jurisdictions with taxes paid in low-tax countries. Under the prevailing Irish CT rate, MNEs would be required to top up their tax payments on profits in Ireland to meet the minimum 15 per cent rate, possibly to the jurisdiction of the ultimate parent company although this is currently uncertain. This would reduce the relative attractiveness of the Irish system.

Current Department of Finance projections allow for a €2 billion loss of CT revenue by 2024, although there is a very high level of uncertainty surrounding this assumption. In considering the potential impact on the economy, it is useful to distinguish between two possible channels. The reforms could reduce the amount of global profits allocated to Ireland by MNEs with a knock-on reduction in

[8] See https://www.g7uk.org/g7-finance-ministers-and-central-bank-governors-communique/
[9] See http://economic-incentives.blogspot.com/2021/04/the-extra-ordinary-tax-payments-of-us.html

corporation tax revenues but with little effect on multinational activity in Ireland. This scenario would involve an unwinding of some of the exceptional/excess corporation tax receipts collected since 2015, and the challenges this would pose to the tax base necessary to support sustainable expenditure over the longer-term. A second more negative outcome is possible whereby the changes result in a loss of CT revenue along with reduced FDI and related multinational activity and employment in Ireland. This second scenario would have more serious implications for the public finances since it would not only reduce corporation tax revenue but also potentially lead to lower revenue from other sources such as VAT and income tax.[10] The details of the changes under both pillars of the BEPS process have yet to be finalised and approved by all OECD members. If a final agreement is reached, further analysis will be required to assess the implications for the Irish economy and public finances.

[10] Data from the Revenue Commissioners show that employees of MNEs accounted for around half of the income tax and USC paid by all companies in 2019. Around 40 per cent of VAT paid by all companies was paid by MNEs. See: https://revenue.ie/en/corporate/documents/research/ct-analysis-2021.pdf