

Economic Reform Group

The Case for Reduced Corporation Tax - A Supporting Update

Report

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web: ergni.org
email: info@ergni.org



Northern Ireland Economic Reform Group

The Case for Reduced Corporation Tax

A supporting update by the Northern Ireland Economic Reform Group adding to the 2010 report which underpinned the Secretary of State's support for this policy.

1. Since the launch in February last of the Report on Corporation Tax by the Northern Ireland Economic Reform Group (NIERG) and the subsequent declaration by the Coalition Government of its intention to pursue the idea of Northern Ireland as an Enterprise Zone, with a low rate of corporation tax as its centrepiece, there has been an increasing volume of debate, most of it very positively disposed towards the idea. Almost a year on, with reports pending from the Treasury and the Northern Ireland Affairs Committee, the NIERG has been taking stock. Our analysis is summarised under five main headings.

A. The Benefits for the Northern Ireland Economy

2. It is even more apparent now than it was when the NIERG Report was written how widespread is the consensus in the Republic that the 12½% rate of corporation tax has been critical to its success in attracting such a strong flow from the higher end of foreign direct investment (FDI). Also widely recognised is the role played by FDI in transforming the Republic into a major production platform for internationally traded goods and services. Export performance has remained remarkably robust during the global economic and financial crisis.

3. The Republic's position is considered further in a recent NIERG Press Release which is attached.

4. There is no reason to suppose – and there is certainly no convincing evidence – that the effect of a low corporation tax rate in Northern Ireland would be any less catalytic than it has been for the Republic. It would make the Province (which already has many of the characteristics that attract investors) a credible location for the very profitable companies seeking host locations that maximise the post-tax return on investment. We are simply not even on their radar screen at present, whereas there are formidable clusters of such investment in the Republic.

5. The NIERG rejects the argument that our business environment is insufficiently prepared to accommodate a strong flow of sophisticated investment. On this score Northern Ireland can confidently stand comparison with its peers, as the success of many of its existing companies attests. It is, of course, essential that, like any ambitious region, we should be constantly seeking to enhance our competitiveness. However, Northern Ireland, like the Republic, would find that, by demanding world-class standards, high grade global investment assists that process by leveraging the entire economy. As Northern Ireland learned when it proved itself in the 1960s a highly successful location for FDI, what is vital is the agility to respond promptly to the demands imposed by world-class investment.

6. To argue for high value-added, R&D-driven FDI is not to downgrade the need to extract every ounce of potential growth from companies (including SMEs) already established here. But relying on growing our own timber is not enough. Without tapping global investment flows, it will simply not be possible to create a private sector

with the critical mass necessary to rebalance the economy. A strong FDI base generates growth opportunities for the rest of the economy and boosts overall performance.

7. No alternative strategy for getting on to a different trajectory has been identified. Tax credits, for example, achieve nothing which cannot be achieved by grants. Tax credits are in the tradition of measures to facilitate or incentivise companies to undertake certain activities by reducing the cost to the company. They are not an alternative to a low corporation tax regime. It is significant that although the Republic (like Northern Ireland) has an R&D tax credit scheme, it has not chosen to abandon its 12½% rate of corporation tax in favour of tax credits. It is clear that tax credits and grants incentivise cost minimisation, which can in turn be trumped by locations offering lower costs. On the other hand low corporation tax encourages profit maximisation which encourages long term stability of the entity generating those profits

B. Enabling Northern Ireland to Set Its own Corporation Tax Rate

8. As definitively confirmed in the expert evidence given recently to the Northern Ireland Affairs Committee, the Azores judgement set out clearly the circumstances in which a region within a national entity could determine its own corporation tax rate. Government lawyers have ruled that, if necessary, steps could be taken which would enable those circumstances to be satisfied in Northern Ireland. The Azores judgement imposed no sectoral restrictions on the type of investment which a region with a differential tax rate can attract.

C. *The Cost to Northern Ireland of a Corporation Tax Reduction*

9. An important Azores requirement is that the region, not the national entity, must bear the consequences of any loss of tax yield through a reduction in the rate of tax. This means that if, as is normally assumed, measurement of the fiscal consequences of tax change is limited to corporation tax, the amount of resources available to the public sector in Northern Ireland would be reduced by a sum equal to any loss of yield from that particular tax. However, as the economy expands, the yield from other taxes would increase and the net loss to the Exchequer would, to that extent, be less. Further consideration needs to be given to finding an equitable basis for dealing with this issue which is compatible with the Azores requirement.

10. In the absence of firm data about tax revenues in Northern Ireland and how they are composed, assumptions have to be made. Often these take the form of attributing to Northern Ireland a percentage of the relevant tax yield in the UK. Most assumptions hitherto regarding the loss of yield from corporation tax have been of the order of £200m/£300m, which is equivalent to some 2%/3% of the Executive's Budget.

11. Fears have been expressed that corporation tax reduction is unaffordable. It would be premature to reach such a conclusion before a number of points have been considered:

- (i) The issue raised at paragraph 9 above would have to be clarified before the true costs to Northern Ireland of corporation tax reduction could be properly estimated.

- (ii) Experience elsewhere (e.g. in the Republic) suggests that there are effects flowing from tax reduction which tend to boost rather than diminish tax yields. The net outcome is therefore difficult to predict and it is important to guard against jumping prematurely to unnecessarily adverse conclusions.

- (iii) Any necessary public expenditure adjustment lies some years ahead and the issue of affordability would therefore fall to be considered in what could well be a very different context from today. Moreover, if the lower tax was phased in, the cost would also be correspondingly phased.

- (iv) For purely illustrative purposes, a possible scenario on the basis of (iii) would be:
 - 2011. Agreement is reached to devolve to Northern Ireland the power to vary corporation tax and the necessary power is conferred.

 - Early 2012. The Executive indicates that it will be shortly introducing legislation so that from [April 2017] the corporation tax rate in Northern Ireland will be 12½% and that it will reduce to that figure in [4] equal steps.

12. In other words, the Executive would have the ability to pace and manage the process by which corporation tax reduction is achieved in light of circumstances at the time. The announcement that Northern Ireland is on course to achieve low tax status would send a powerful signal which would become central to the successful marketing of Northern Ireland as an investment location. Provided there was a firm date for attainment of the 12½% rate, companies would not be

concerned about phasing. By the time they were settled in and making significant profits, the benefit of the full tax reduction would be available to them and, in the meantime, the tax rate would be reducing. In order to give investors confidence and encourage significant FDI, it would be vital that the Executive should make clear its long-term commitment to a low corporation tax regime.

13. The critical choice for Northern Ireland now is therefore whether or not **to obtain the power** to set its own rate of corporation tax if it chooses to do so. It is difficult to see on what grounds it would deny itself the ability ever to deploy such a powerful economic tool or how that denial would be justified to subsequent generations. It would be unrealistic to suppose that, if the present Government is prepared to devolve the power and its willingness is rebuffed, the opportunity would recur.

D. The Cost to the UK Government

14. Like any other tax change, this one would give rise to administration costs for HMRC. There would also be lost tax revenue if companies decided to relocate from Great Britain to Northern Ireland. There are, however, advantages (the phenomenon of 'externalities') for companies embedded in a particular location in staying where they are even if for tax reasons they might prefer to be elsewhere. Few, despite dissatisfaction with the UK corporation tax regime, have hitherto chosen to relocate. There would in future be benefits to the UK if those that did so relocated to Northern Ireland rather than elsewhere. There would also be loss of tax revenue if companies contrived to shift to Northern Ireland profits not arising from activities in Northern Ireland. NIERG, having examined this issue in depth, is satisfied that attempted profit

shifting of this kind can be satisfactorily policed without incurring significant extra costs.

15. The extent of any losses to the Exchequer will therefore depend on company behaviours that cannot be predicted with any certainty. To assume that they would be substantial would be as unwarranted as to discount them totally. It also has to be remembered, as a countervailing factor, that an increasingly vibrant Northern Ireland economy would generate increasingly buoyant tax revenues from taxes whose proceeds would accrue directly to the Exchequer, not to the Executive.

16. The fundamental issue is therefore:

- (i) whether a low rate of corporation tax would create a situation where the Exchequer support needed to maintain living standards in Northern Ireland can progressively reduce; and
- (ii) whether the Government is prepared to accept (just as the Executive for its part would have to accept) that there are costs involved in achieving to mutual advantage a new trajectory for Northern Ireland.

17. There would also be compliance costs, which need not be significant, for companies, particularly for those operating in both Great Britain and Northern Ireland. However the reduced rate of corporation tax should more than compensate any additional compliance costs.

E. Concluding Comments

18. Northern Ireland is at a crossroads in terms of its economic strategy. One option is to make its way as best it can through the present age of austerity, and the Executive's draft Budget indicates the route likely to be taken. In the absence of any new policy démarche, the existing instruments can be used to encourage the growth of the business base and to attract the kind of FDI whose needs are met by Northern Ireland's existing incentives. It would be a matter of hoping that policies which have hitherto failed to effect significant change will do so in the future. However, it should be noted that, unless some variation can be specially negotiated, State Aid constraints from Brussels will seriously impair Northern Ireland's ability to incentivise new FDI.

19. On this basis it is difficult to see why or how the Northern Ireland economy would perform better than it has in the past. At best, the gap with the rest of the UK is likely to persist, with public sector dependency remaining high and with the brain drain of local talent unable to make satisfactory careers in Northern Ireland continuing.

20. Alternatively, Northern Ireland can learn from the Republic's exceptional success in attracting high value FDI and adopt the policy tool which those responsible for that success regard as crucial, as the attached Press Release makes clear. NIERG has estimated the likely outcome in terms of jobs at some 90,000 over 20 years. If policy is intended to be evidence-based, it is difficult to identify an economic policy hitherto adopted in Northern Ireland which is supported by more compelling evidence.

21. This alternative comes at a price. Resources have to be diverted to fund an investment – in this case a powerful new policy tool - with transformational potential. This is akin to the decisions companies and households make on a daily basis. The choice is between acquiescing in the condition of permanently lagging region and persisting with the status quo **OR** making the investment and striking out boldly in a new direction which offers the strong prospect of a much more rewarding economic future for all.