corporation tax

SUB/00743/9r 28/6

~~Mr~~ Gamble

CONFIDENTIAL - POLICY

A432/94

cc Secretary
Mr McCann
Mr Gibson
Mr McDonnell
Mr Gamble o/r
MC

28 June 1995

Minister: paper on possible benefits of revising the NI tax structure as requested
SMcK 28.6.

To: PS/Baroness Denton (DED)

From: D MacCann
Strategic Planning Unit

DEPARTMENT OF ECONOMIC DEVELOPMENT
28 JUN 1995
PRIVATE OFFICE

CORPORATION TAX

1. This submission is a response to your minute to Roy Gamble of 12 June on the above. Mr Gamble is on leave and has asked me to respond.

2. The paper is restricted to the examination of the likely effects of reducing the Corporation Tax rate for manufacturing to 10%, the level in the RoI. The Minister will recall that other tax measures to assist local business were put forward to the Chancellor for inclusion in last year's Budget. None was accepted then and two of them - abolition of the duty on heavy fuel oil for electricity generation and the acceleration of capital allowances - are being considered for re-presentation for this year's Budget.

3. The difficulties in the way of concessions on Corporation Tax for Northern Ireland are well known. HMT will strongly oppose such a move, arguing that the main rate of Corporation Tax of 33% in the UK (down from 52% over the last decade) is low by international standards, that the net benefit in terms of employment or income is likely to be negligible and that the potential cost to the Exchequer, particularly as a result of tax evasion activities such as transfer pricing, is likely to be large. There may be opposition from the European Commission particularly if the policy

NRC 0564JM

DEPARTMENT·OF·ECONOMIC·DEVELOPMENT·
An Equal Opportunities Organisation

is introduced in such a way as to be identified as a state aid. There may also be opposition from some sections of local unionist opinion which may regard any diminution in the unitary tax structure of the UK as a threat to the political union.

4. Those caveats having been made, the rest of this paper focuses on two issues - the likely economic impact, in terms of employment, in Northern Ireland of a reduction of the Corporation Tax rate to 10% for manufacturing industry and the likely cost to the Exchequer of such a policy. The possible implications for the Northern Ireland Block are also discussed; to the extent that any Exchequer costs of the policy are imposed on the Northern Ireland Block, the positive employment effects will be diminished. The paper assumes that eligibility for the lower tax rate applies to all manufacturing in Northern Ireland including all new manufacturing projects. In the RoI, selected tradeable services also benefits from the low tax rate but, for simplicity, this paper ignores such an extension. The effects of applying the lower rate to all new and to new non-UK manufacturing projects only are set out briefly at Annex A.

5. Underlying the considerable number of calls recently for Northern Ireland's corporate taxation to match the Republic's is the assumption that this will necessarily bring significant economic benefits to the Northern Ireland economy. These calls for change have not however been supported by any numerical analysis. Estimates of the likely economic benefits must be speculative, but the impact is likely to be both on output (GDP) and employment. The experience of the RoI suggest that much of the increase in GDP is likely to be lost to the local economy by repatriation of profits. This paper therefore concentrates on the likely employment effects.

Impact on Employment

6. A reduction in the Corporation Tax rate should lead to a greater willingness to invest in Northern Ireland. Much of this is likely to be in increased inward investment both from existing inward investors and those investing in Northern Ireland for the first time. Comparisons with the RoI suggest that, after adjusting for differences in the size of the two economies, the level of inward investment in the Republic is around 2½ times that of Northern Ireland - equivalent to an additional 4,500 job promotions per annum. It is not clear to what extent the RoI's better performance reflects its Corporate Tax regime; clearly its freedom from Northern Ireland's troubles has also had a significant effect on the differential.

7. The DED paper on the 'Peace Dividend', produced last year, estimated that a permanent cessation of violence (without any reduction in Corporation Tax) could increase inward investment into Northern Ireland by between 50% and 100% leading to an increase in job promotions of between 1,500 and 3,000 per annum. This estimate was supported by a number of external studies including one produced by the CBI. The lower figure of 1,500 has already been incorporated into IDB's job promotion target for 1995/96 and, as external investors increasingly view the peace as permanent, an increase towards the higher 3,000 figure might be expected. This suggests that any additional job promotions as a result of a lower Corporation Tax rate might be around 1,500, thereby eliminating the 4,500 job promotions gap between Northern Ireland and the Republic. This figure is in line with an estimate produced by NIERC/Colin Stutt Consulting in a paper assessing the social and economic consequences of the peace process currently being prepared for the Forum for Peace and Reconciliation.

8. An increase in job promotions of 1,500 per annum would, on the basis of established job promotion to creation ratios and job duration profiles, lead directly to an increase in the stock of manufacturing employment of around 9,000 jobs after a number of years. Linkage and multiplier effects could lead to a further 4,000 jobs being generated in both manufacturing and elsewhere in the local economy, making a total of 13,000 altogether.

Net Exchequer Costs

9. The costs to the Exchequer of a reduction in Corporate Tax is likely to be of two broad types:

- the deadweight losses associated with reduced payments of corporation tax on profits which would have been generated within Northern Ireland in any event; and

- the costs resulting from tax evasion activities in particular transfer pricing by firms with activities located in both Northern Ireland and GB.

10. On the other hand there are potential gains to the Exchequer:

- there would be additional tax receipts from the additional companies attracted to Northern Ireland by the lower tax rate. This effect can be expected to be magnified as a result of a change in the character of inward investment, towards projects which are more profit intensive. (Estimates for the RoI show that foreign manufacturing firms have a profit per head level of six times the average for all manufacturing firms in Northern Ireland and almost eight times the level for indigenous manufacturing firms in the RoI. The greater level of profit in such projects reflects the fact that a lower Corporation Tax rate is more likely to attract projects which are intrinsically more profitable; it however may also reflect a significant element of transfer pricing.) Consequently while the lower tax rate may mean lower potential receipts, higher profitability may generate significant offsetting gains;

- there may also be some gain to the Exchequer (in the form of reduced benefit payments/higher tax receipts) if the additional jobs created allow unemployment (in the UK as a whole) to be lower than it would have been in the absence of the policy. Such a decrease in unemployment would not match on a one for one basis any increase in employment in Northern Ireland but some effect might be claimed particularly if the jobs created were to bring numbers of the long-term unemployed back permanently into the labour market. (HMT will argue that the impact on unemployment, because of displacement and crowding out, is likely to be close to zero for the UK as a whole.);

- finally, on the assumption that of lower Corporation Tax will mean that expenditure on SFA by IDB can be reduced, there will be a further saving in public expenditure. A key question is whether this saving is retained in Northern Ireland and redeployed or returned to HMT as a saving to the Exchequer.

11. Annex A outlines some estimates which suggest that a reduction in Corporation Tax which applies to all manufacturing firms (option a) will have a significant net Exchequer cost - perhaps around £100m per annum with the costs even greater in the earlier years. With the more restrictive options (b and c) the costs and savings tend to cancel each other out though even with these, deadweight losses will tend to increase over the longer term.

12. In addition to consideration of options with respect to coverage, it will also be necessary to consider options on duration of the tax concession. A lower rate of Corporation Tax for an indefinite period is unlikely to be acceptable to either HMT or the EC. A concession until 2010 in line with the RoI may be acceptable to the Commission. A more limited scheme whereby the tax concession lasts to 2010 but is only applicable to investment projects which commence within a much shorter time period, say before 2000, may be more acceptable. Such an approach would have the advantage of being only a very temporary move away from the UK's unitary tax system and one which is seen as directly capitalising on the peace process. It would also tend to limit the rising deadweight losses associated with options (b) and (c). It may, however, be that there would be administrative problems in applying time - limited schemes.

13. In addition to the costs and benefits noted above, any assessment of a reduction in Corporation Tax must take into account a number of other factors.

Where an option is judged to have a net cost to the Exchequer there may be a demand from HMT for a compensating reduction in the Northern Ireland Block. If for example the £100m net Exchequer cost of option (a) was imposed on the Block, an estimated 4,000-5,000 jobs could be lost, significantly reducing the net employment impact of a Corporation Tax reduction.

A move from an SFA incentive package to a tax based approach reduces IDB's influences over the type of inward investment coming to Northern Ireland. NIERC in its recent publication 'The Economic Implications of Peace and Political Stability For Northern Ireland' has, for example, argued that the type of foreign investment attracted by the RoI creates few linkages with the rest of the domestic economy and has low levels of R&D and hence is not attractive in terms of wider industrial development. There is clearly a danger that once the Corporation Tax incentive is removed that much of this type of industry, if it is not embedded in the local economy, will leave.

A move away from the SFA approach also makes Northern Ireland less attractive to some investors. There is a view that SE Asian investors are more attracted to capital grants up front rather than lower Corporation Tax rates later. In addition there are increasing signs that Governments are trying to tighten up on the use of low-tax jurisdictions by multi-nationals. The 'shelf-life' of low Corporation Tax as an inward investment incentive might be limited.

14. **In Conclusion**

- In terms of employment the introduction of a lower rate of Corporation Tax could increase employment by between 9,000 and 13,000. Any deal with HMT which involved a compensatory reduction in the Northern Ireland Block would reduce these employment gains.

- The net costs to the Exchequer of such a proposal can only be speculative and will vary with the option chosen. The wider the coverage the greater the deadweight effect and hence the greater the costs. An option which allows existing industry to benefit from any reduction in Corporation Tax is estimated to have a net Exchequer cost of around £100m per annum after several years with the costs being even greater in the earlier years. Options which restrict the coverage of the lower tax rate to new investment appear to be more balanced in terms of Exchequer costs though, if the tax reduction is to run for a long period of time net exchequer costs are likely to occur.

- A proposal which allows such a tax concession for a relatively short period of time is likely to be more acceptable to HMT. The increasing deadweight costs noted above will be limited, the scope for transfer pricing may be reduced and the principle of a unitary tax system throughout the UK may be perceived as less threatened.

- There is a danger that the type of inward investment attracted by such a proposal may not be in the long-term, wider industrial development interests of Northern Ireland.

- On balance therefore the potential economic benefits to Northern Ireland of such a proposal may not be sufficiently large to justify entering into what is likely to be a long and difficult battle with HMT and one where the chances of a successful outcome cannot be considered high.

D MacCann

D MacCANN

·DEPARTMENT·OF·ECONOMIC·DEVELOPMENT·
An Equal Opportunities Organisation

CORPORATION TAX **ANNEX A**

COSTS AND BENEFITS

1. In assessing the likely costs and benefits, there are three main options with regard to eligibility for the lower tax rate:

   (a) all manufacturing in Northern Ireland;

   (b) all new manufacturing projects; and

   (c) only new non-UK manufacturing projects.

2. Options (a) and (b) are likely to be similar in terms of their impact - a build up over a number of years (as outlined in the main paper) to 13,000 additional jobs (including multiplier and linkage effects). Under option (c) new UK projects are excluded and therefore the employment impact is likely to be less. An additional 1,000 job promotions per annum is assumed building up over time to an extra 9,000 jobs.

3. In terms of exchequer costs there are likely to be differences between the three options. Options (a) and (b) suffer from significant deadweight losses. Under option (a) existing industry immediately obtains a large reduction in Corporation Tax without any increase in activity. Under option (b) the deadweight loss will not be so large immediately but over time as 'new' manufacturing projects replace 'existing' projects the coverage of the lower rate of tax will tend to increase. Under (c) the potential for deadweight is significantly reduced though here again, as in (b), there will be scope and incentive for (non-UK) existing inward investment projects to transform themselves into 'new' projects in order to benefit from the lower tax rate. Limiting the duration of the lower tax regime and in particular

the period within which investments must occur to be eligible for it could reduce the 'creeping' deadweight effects of (b) and (c).

4. Estimates of net Exchequer costs are outlined in the table attached. The net Exchequer costs can vary over time for each of the options. For example while the loss of tax receipts from existing industry all occur almost immediately under option (a) it will build up slowly under options (b) and (c). On the other hand any gains from the attraction of more profit intensive industry will build up slowly over time. In order to allow for these build-up effects the estimates represent the annual net Exchequer costs (1993 prices) several years after the introduction of the lower tax rate.

5. In looking at the table in the table it can be seen that the net Exchequer cost estimates contain five elements:

- There is a significant deadweight loss of receipts from existing industry. This falls as eligibility for the lower tax rate is restricted.

- There is the potential for significant additional receipts if lower tax rates attract in very profitable industry. The figures at the lower end of the range assume that not all, but only some, of the new investment projects occurring under the new tax regime are profit intensive; the upper range estimates assume <u>all</u> future inward investment projects are profit intensive.

- A widely accepted estimate is that the annual net exchequer savings of moving an unemployed person into employment is about £8,000 on average. It is assumed that lower

Corporation Tax leads to a permanent net reduction in UK unemployment equivalent to 25% of the additional jobs created.

- It is assumed that a reduction in Corporation Tax will lead to a significant reduction in SFA. For options (a) and (b) £50m is assumed; for option (c) which does not cover Northern Ireland or GB projects, the reduction is assumed to be less, at £30m.

- It is likely that any reduction in Corporation Tax will lead loss of Corporation Tax receipts through transfer pricing by GB based companies. It is difficult to put an estimate on this but it is likely to be correlated with the level of profit intensive inward investment. The tax losses due to transfer pricing by GB based companies are assumed to be equivalent to $^{1}/_{3}$ the additional profits generated in Northern Ireland due to greater profit intensity. In effect this cost tends to cancel out any tax receipt gains from the attraction of more profit intensive industry (see (ii) and (v) in the attached table).

TIMATED NET EXCHEQUER COSTS OF REDUCING CORPORATION TAX TO 10% IN NORTHERN IRELAND

		OPTIONS FOR CORPORATION TAX REDUCTIONS		
		(a) ALL MANUFACTURING	**(b) NEW PROJECTS**	**(c) NEW NON-UK OWNED PROJECTS**
		£m	**£m**	**£m**
(i)	REDUCTION IN CORPORATION TAX RECEIPTS TAKE FROM EXISTING INDUSTRY	-159	-39	-20
(ii)	INCREASE IN CORPORATION TAX RECEIPTS AS A RESULT OF ADDITIONAL/MORE PROFIT INTENSIVE INWARD INVESTMENT	28 TO 113	28 TO 113	19 TO 61
(iii)	BENEFIT SAVING/INCREASED TAX RECEIPTS FROM REDUCED UNEMPLOYMENT	26	26	17
(iv)	REDUCTION IN SFA	50	50	30
(v)	REDUCTION IN CORPORATION TAX RECEIPTS DUE TO TRANSFER PRICING	-31 TO -124	-31 TO -124	-21 TO -67
	NET EXCHEQUER COST[1]	-94 TO -86	26 TO 34	21 TO 25

1 A POSITIVE FIGURE IS A NET GAIN TO THE EXCHEQUER

12/6

MOM/00308/a

MC GAMBLE

cc Mr Loughran
Mr McCann
Mr Gibson
Mr McDonnell
MC

BF 23/6.

To: Mr Gamble

From: PS/Baroness Denton

CORPORATION TAX

Baroness Denton is particularly concerned about Northern Ireland's difficulty in competing with the Republic of Ireland for inward investment projects because of the Republic's corporate tax structure.

The Minister would be grateful if you could prepare a paper which evaluates the potential benefits to Northern Ireland of revising our tax structure, and explores the possible options.

The Minister would be grateful for your advice please by 23 June 1995.

G. Mallon

GERRY MALLON
Private Secretary

12 June 1995

DEPARTMENT OF ECONOMIC DEVELOPMENT