Northern Ireland Assembly

The Open University Business School

Economic Challenges and Opportunities of Devolved Corporate Taxation

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Preamble

The Research and Information Service Briefing Paper *A Review of Literature Regarding the Determinants of Foreign Direct Investment (FDI)* (NIAR 862-14 by Daniel Donnelly) gives a fair summary and overview of the issues concerning the drivers of inward FDI and in particular the role of corporation tax. With the announcement of Northern Ireland being permitted to set a rate equivalent to that of the Republic of Ireland (ROI), there has been a renewed interest and focus on the role of cutting taxes on corporate activities in attracting FDI. This takes place against the background of particular global companies exploiting tax differences within the European Union. In particular, the ending of the “double Irish[1]” has created an over-emphasis on the role of corporate taxation in attracting FDI leading to increased economic growth and employment in the recipient country. Moreover, this has created a consensus that the attractiveness of the ROI for FDI inflows is solely a function of its rate of corporation tax. Like most discourses centred on a single consensus, a degree of complexity is hidden as the report published by the United Nations Conference on Trade and Development (UNCTAD)[2] notes:

> *The role of incentives in promoting FDI has been the subject of many studies, but their relative advantages and disadvantages have never been clearly established.*

[1] The double Irish loophole allows US companies to reduce their tax bill far below Ireland’s 12.5% corporate tax rate by shifting most of their taxable income from an operating company in Ireland to another Irish-registered firm in an offshore tax haven such as Bermuda. The ending of this loophole will be phased over a four year period.

[2] UNCTAD (2000) *Tax Incentives and Foreign Direct Investment: A Global Survey,* ASIT Advisory Studies No. 16, Geneva: UNCTAD. http://unctad.org/en/Docs/iteipcmisc3_en.pdf

There have been some spectacular successes as well as notable failures in their role as facilitators of FDI. As a factor in attracting FDI, incentives are secondary to more fundamental determinants, such as market size, access to raw materials and availability of skilled labour. Investors generally tend to adopt a two-stage process when evaluating countries as investment locations. In the first stage, they screen countries based on their fundamental determinants. Only those countries that pass these criteria go on to the next stage of evaluation where tax rates, grants and other incentives may become important. Thus, it is generally recognized that investment incentives have only moderate importance in attracting FDI. UNCTAD (2000, 11)

In assessing the economic challenges and opportunities of devolved corporate taxation a number of issues arise:

- The new tax environment within which the Northern Ireland economy would operate will be different from hitherto so that multiplier effects and the tax elasticity of supply may be dissimilar than those currently estimated;
- Estimating the net impact on the fiscal position from tax changes and the reduction of corresponding amount of block grant and the transitional arrangements and their timing is uncertain;
- High profile European Union (EU) cases being brought against global companies for tax avoidance, accompanied by public pressure and campaigns, leading to greater pressures to harmonise corporation tax rates within the EU;
- The degree to which the Azores Judgment[3] would impinge on discretionary changes in corporation tax rates by being viewed as a form of state aid, balanced by pressures to re-negotiate associated regulations;

[3] The Azores judgement reaffirmed the EU principle of that *the infra-State body not only has powers in the territory within its competence to adopt measures reducing the tax rate, regardless of any considerations related to the conduct of the central State, but that in addition it assumes the political and financial consequences of such a measure.* http://www.reckon.co.uk/item/38dd5bd2

- The possibility of a new constitutional settlement in the United Kingdom leading to more devolved fiscal powers may lead to greater tax competition between devolved nations and regions;
- By changing the effect exchange rate of business operating both sides of the border with the Republic, an All Island approach may give Northern Ireland access to a larger market and encourage more innovation hubs: both key drivers of FDI;
- Distinguish between investment/income and employment generating FDI as a result of cutting the rate of corporation tax. The former includes the MATRIX sectors whilst the latter includes financial services (particularly back-office functions) and other tradeable services.
- The locational stability of the different sectoral composition of FDI. For example, financial and business services are more globally mobile than aerospace and advanced engineering:
- Targeting the key MATRIX sectors may stimulate greater innovation and cluster development leading to increased productivity through process innovation;
- This targeted approach should be seen as part of a regional industrial policy in order to develop and sustain Global Value Chains (GVCs) that may stimulate investment and growth from FDI leading to employment effects and widening of the tax base, although these would be indirect;

Table 1 gives an overview of some of the effects arsing from devolved corporate taxation. The shaded areas represent the current policy choices (rows 1b and 3) with highlighted text (row 3a) a future possibility. The degree to which other incentives and mechanisms will be introduced will depend upon the impact of changes in corporation tax. These may be positive and negative but at present the size and scale linkages between increased FDI investment growth and employment are uncertain.

Table 1: Selected Fiscal Measures to Promote Investment and Technological Upgrading

Tax incentive & mechanism	Objectives	Coverage	Advantages & drawbacks (partly depend on objectives)
1. Corporate tax instruments*:* *Reduced corporate tax rates (Not period – see tax holidays).*	To reduce effective tax rate (take) with waivers or reductions.	Broad coverage of profitable income -generating firms or targeted base of selected activities, sectors or firms. Does not apply to unprofitable firms.	• Tax rate has to be below global norm 35-40% for full effect; • Lower tax rates confer benefits over a longer time; • Less immediate benefits to income-generating firms; • Reductions in corporate tax rates can reward old capital more.
1a. Broad base: *Reduced corporate tax rate on all firms (e.g. Hong Kong)*	To minimise market distortions.	Broad firm base.	• Simplified system; fewer market distortions. • Perceived to be fair – affects all firms in same way. • Confers LT benefits more slowly and rewards old capital.
1b: Selective Approach: *Reduced corporate tax rates for selected activities and sectors.*	To target beneficial industries and activities of perceived advantage.	Specific targeted industries and activities; Existing firms and/or potential investors.	• Important signalling effects about government commitment and commitments to stimulate FDI; • Generally easier to implement than general reforms; • Results depend on sector choice; may distort the market
2.Tax holidays and temporary rebates *Operate through a waiver or exempt/reduced periods for corporate tax.*	To provide support to firms in specific activities, especially new firms in their start-up phase. To encourage new investment	Popular in developing countries with a discretionary approach. Can be used to target specific industries and activities, for existing forms and/or potential investors	• Discretionary approach; risks introducing market distortions. • Flexible, according to government objectives; • Immediate benefits to firms/start-ups as soon as earn income; • May reward founding business start-ups, rather than ongoing investments in existing companies; and LT investments; • Potential for tax planning across periods & revenue leakage • May reward ST investments in 'footloose' industries.
3. Investment tax allowances: • accelerated depreciation; • expenditure allowances; • tax credits.	To support expansion in existing firms; To encourage long-term investment.	Widely used in industrialized countries; cover firms making investments; Generally focus on specific sectors	• Promote LT capital investments and current spending, causing less revenue leakage than tax holidays; • Promote new investment; • High inflation erodes value of annual depreciation allowances.
3a. Refundable tax allowances *Refunds from government at later date.*	As above	Firms making investments	• With refundable write-off allowances, investment costs and risks can be shared by government with investors. • Where non-refundable, existing companies reap benefits • Long term projects (e.g. infrastructure) suffer cf. rapid income-earners
4. Exemptions on customs duties or local indirect taxes (e.g. EPZs)	.To encourage export/import activities for TT	Generally for targeted sectors, activities, EPZs.	• Use of customs exemptions has been restricted by trade treaties • Dependent on capacity of custom/tax administrations
5. Outright grants and upfront subsidies; subsidized loans	To facilitate establishment of business & investment	Rarely used by DCs due to upfront costs; used for targeted sectors.	. • Flexible and can directly address objectives, but depend on capacity of tax administrations and may be open to abuse.

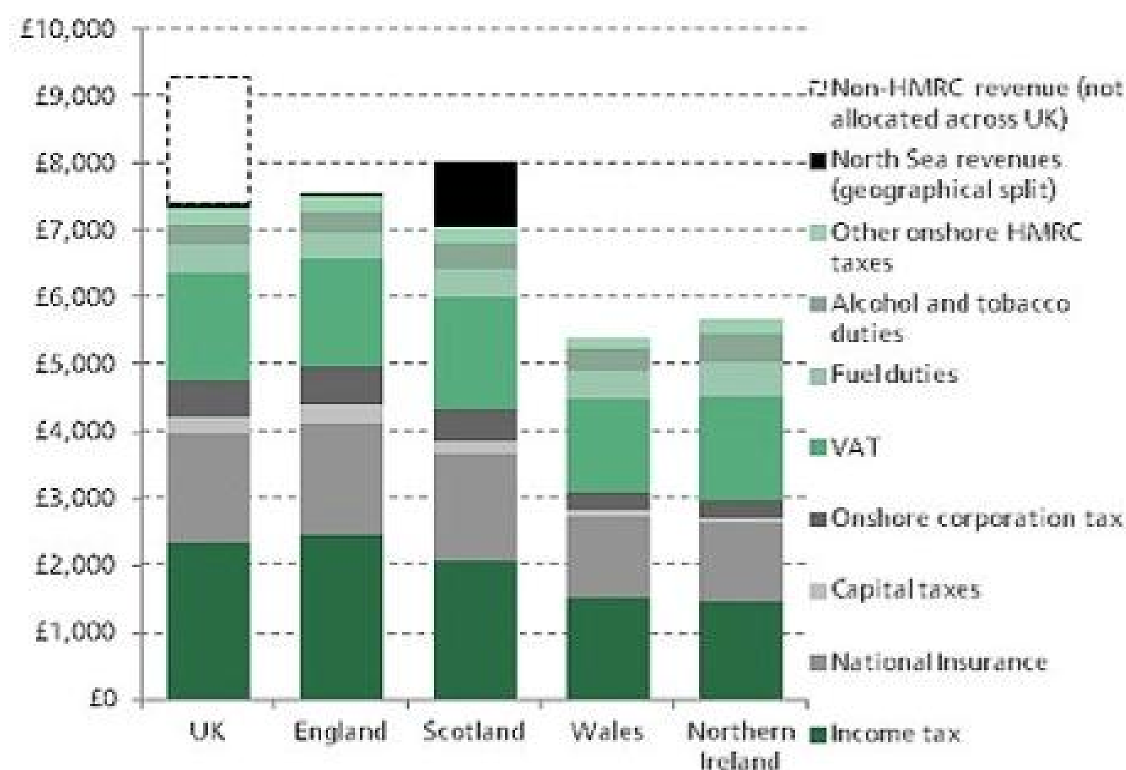
Source Biggs (2007) (adapted from of Morisset & Pirnia, 2000)[4] http://vi.unctad.org/fdiCD/sessions/Session3/Biggs.pdf

[4] Biggs, P. (2007) *Tax Incentives to Attract FDI Meeting of Experts on FDI, Technology and Competitiveness* UNCTAD; Geneva 8- 9 March

Challenges for Devolved Corporate Taxation

Some of the challenges are implicit in the key issues set out above. The major challenge is the degree to which reductions in corporation tax can compensate for any reduction in the block grant. This takes place against the size of the contribution of different taxes to government revenues, shown per person across the nations of the UK in Figure 1 below.

Figure 1: Government Revenue per person across the UK, 2012-13



source: Institute of Fiscal Studies (2014)[5]

The other associated challenge is that the corporation tax base is relatively small in Northern Ireland because of the size distribution of firms:

1. Over three quarters of VAT and/or PAYE registered businesses with a main (or registered) address in Northern Ireland had total employment of less than five.
2. At March 2013, businesses with total employment of less than 50 accounted for approximately 98% of all VAT and/or PAYE registered businesses in Northern Ireland.
3. Businesses with 50-249 employees accounted for 1.5% of the total.

[5] http://www.ifs.org.uk/publications/6881

4. Businesses with 250+ total employment accounted for 0.3%.
5. Businesses with total employment of less than 10 accounted for 89.0% of the Northern Ireland total.

Similarly the total contribution of corporation tax to the UK Exchequer has been consistently small, peaking at 2.0% in 2005-07, then declining since, as shown in Table 2.

Table 2: Corporate Tax (Onshore) receipts across UK (£m)

	United Kingdom	England	%	Wales	%	Scotland	%	Northern Ireland	%
1999-00	33,054	29,187	88.3%	760	2.3%	2,578	7.8%	529	1.6%
2000-01	30,092	26,571	88.3%	692	2.3%	2,347	7.8%	481	1.6%
2001-02	28,526	25,188	88.3%	656	2.3%	2,225	7.8%	456	1.6%
2002-03	25,606	22,610	88.3%	589	2.3%	1,997	7.8%	410	1.6%
2003-04	25,020	22,043	88.1%	600	2.4%	1,927	7.7%	425	1.7%
2004-05	29,810	26,143	87.7%	715	2.4%	2,355	7.9%	566	1.9%
2005-06	34,522	30,276	87.7%	829	2.4%	2,762	8.0%	690	2.0%
2006-07	37,599	33,275	88.5%	865	2.3%	2,707	7.2%	752	2.0%
2007-08	40,655	36,020	88.6%	935	2.3%	2,927	7.2%	772	1.9%
2008-09	33,251	29,427	88.5%	765	2.3%	2,560	7.7%	499	1.5%
2009-10	30,807	27,295	88.6%	739	2.4%	2,403	7.8%	400	1.3%
2010-11	35,257	31,238	88.6%	846	2.4%	2,715	7.7%	458	1.3%
2011-12	33,311	29,514	88.6%	866	2.6%	2,498	7.5%	433	1.3%
2012-13	35,059	31,168	88.9%	876	2.5%	2,559	7.3%	421	1.2%
2013-14	35,718	31,753	88.9%	893	2.5%	2,607	7.3%	429	1.2%

source: HMRC (2014)[6]

The other significant challenge is what will be the actual FDI multipliers from tax reductions. For every 1% lowering in corporation tax, the increase in FDI will vary from 1% to 5% according to the OECD[7]. In some estimates the upper range is 6.7% but this was made prior to the financial crisis and the global economy's current under-performance.

One significant factor is what will be the net trade-off cost of the reduction of the tax rate to 12.5%. and the accompanying reduction in the block grant. H.M Treasury estimates that

[6] HMRC (2014) *A disaggregation of HMRC tax receipts between England, Wales, Scotland & Northern Ireland: Methodology Note*, HMRC; London. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/359890/disag-method.pdf

[7] OECD (2008) *Tax Effects on Foreign Direct Investment. Policy* Brief, OECD Observer: OECD; Paris. http://www.oecd.org/investment/investment-policy/40152903.pdf

cuts in the latter of between £300m (3.7%) and £700m (8.7%) per annum. Gerald Holtham[8] estimates that, even if the cut were just £300 million, then compensating for that loss would require an additional £2.4 billion in private-sector profits. This translates into an additional £10 billion of Gross Value Added (GVA) (current figure £28 billion).

It is apparent, however, that the introduction of a reduction in the rate of corporation tax to 12.5% is not just a binary function of the corresponding level of the block grant. This change in policy effectively is part of a new form of regional industrial policy aimed at transforming the Northern Ireland economy. This centres on the links between greater FDI leveraging investment; growth in output; and, subsequent rise in employment. This new environment forms the backcloth of the opportunities arising from corporate tax changes.

Opportunities arising from Devolved Corporation Tax

In 2011 the Economic Advisory Group (EAG)[9] in Northern Ireland produced a report setting out its estimates of economic benefits from a cut to a 12.5% rate. By 2030 this should produce:

- An increase in employment of is anticipated to be 58,000 higher by 2030, representing a 6.7% increase from the baseline;
- FDIs forecast to comprise 42% of the net additional jobs;
- GVA per head is forecast to be 13.5% higher than the baseline, implying convergence on living standards in the rest of the UK;
- Annual average annual GVA is forecast to be around one percentage point higher per year with the economy 13.8% larger by 2030;
- Labour productivity is forecast to be 6.6% higher than the baseline by 2030;
- Exporting activity (is forecast to be 34% higher than the baseline.

There is danger, however, of seeing reductions in corporation tax in order to stimulate inward

[8] Gerald Holtham was Chair of the *Independent Commission on Funding and Finance for Wales* whose work on devolved finance was completed in 2010.

[9] EAG (2011) *The impact of reducing corporation tax on the Northern Ireland economy* EAG; Belfast. http://www.eagni.com/fs/doc/publications/impact-of-corporation-tax-on-ni-eag-report-final-report.pdf

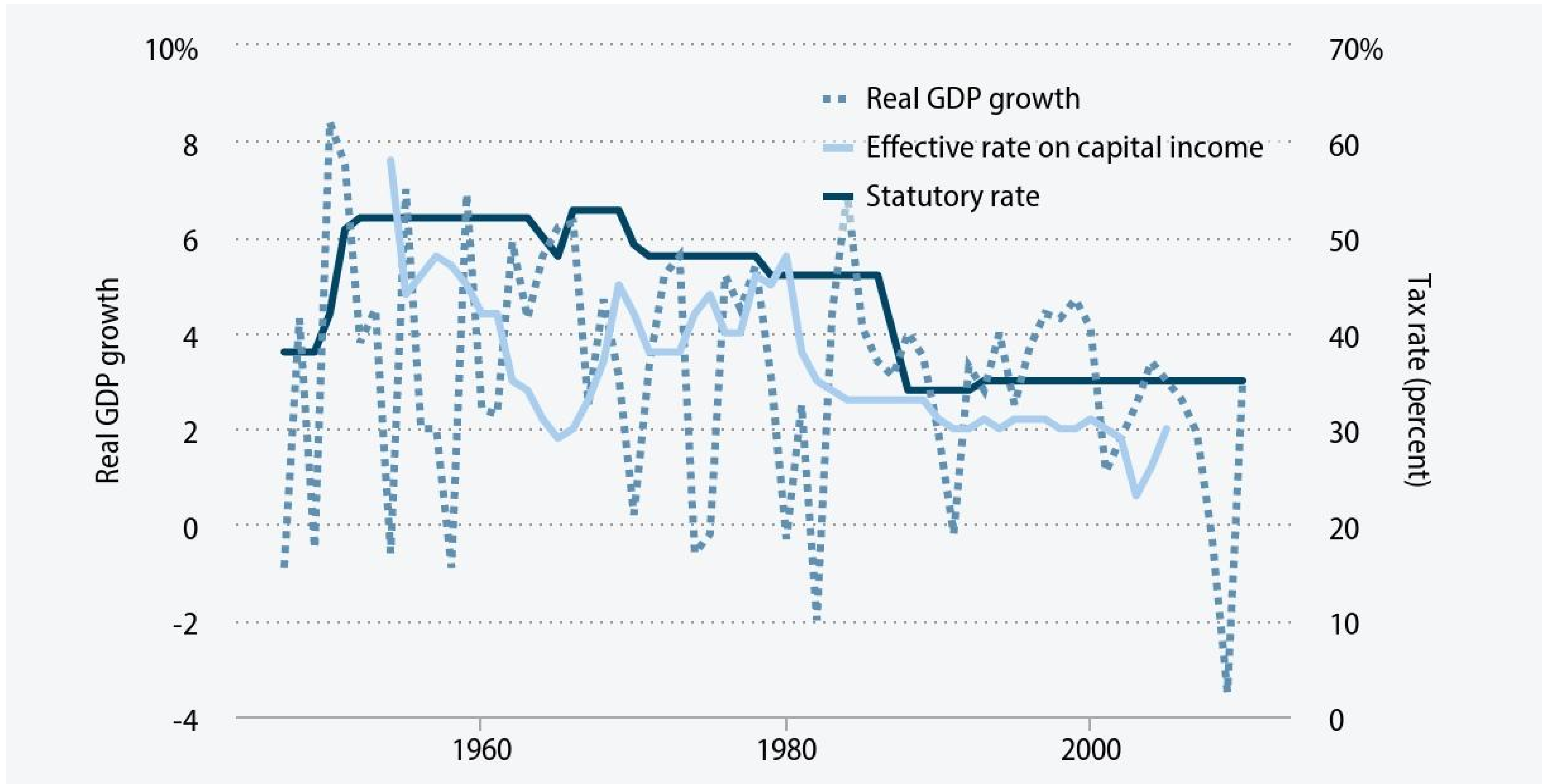
FDI as some kind of silver bullet. This has generated a consensus about the role of a low rate for corporation tax in the ROI being responsible for its dynamic, albeit volatile, growth performance. A challenge to this consensus is set out in Figure 2 below that shows the relationship between corporate taxes and GDP in the US between 1947 and 2010.

The focusing of tax changes, their mechanisms and incentives (for example those set out in Table 1 above) in key targeted sectors is crucial in embedding greater FDI in the economy. An important consideration in delivering economic benefits is the building upon existing and developing new Global Value Chains (GVCs). International production, trade and investments are increasingly organised within GVCs in which the different stages of the production process are located across different countries. Globalisation motivates companies to restructure their operations internationally through outsourcing and offshoring of activities through FDI. They do, however, also encourage re-shoring back to a home base as the dynamics of the global economy evolve. Firms try to optimise their production processes by locating the various stages across different sites. The past decades have witnessed a strong trend towards the international dispersion of value chain activities such as design, production, marketing, distribution and business services. This description equally applies directly to the MATRIX sectors of:

- Telecommunications & ICT;
- Life & Health Sciences
- Agrifood;
- Advanced Materials;
- Advanced Engineering

In the UK, 75% of Business Expenditure on Research and Development (BERD) is accounted for by manufacturing. Likewise, MATRIX type sectors are the source of significant demand for business services. Business services are both globally tradeable and form an important part of the economic framework of any economy. They also form important GVCs

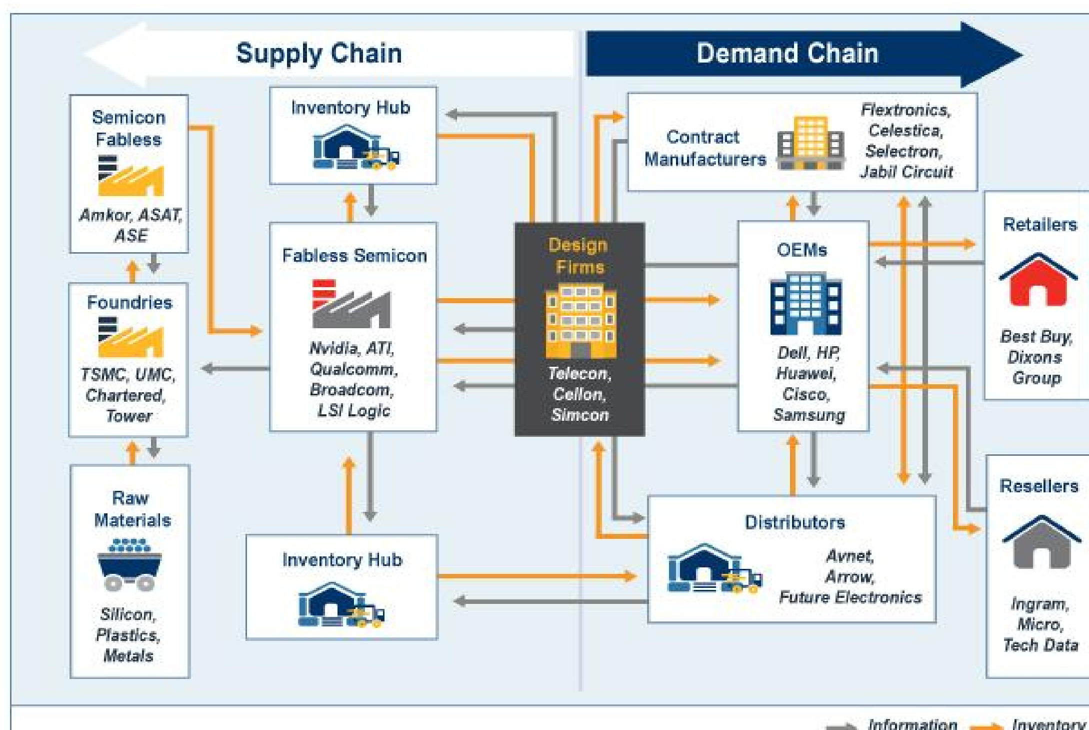
Figure 2: Economic growth rates and effective corporate tax rates in the United States



Source: Hungerford, T.L (2013) "Corporate Tax Rates and Economic Growth since 1947", *Economic Policy Institute(EIP) Issue Brief* no. 364, June. EIP; Washington DC.

underpinning other GVCs in strategic sectors in an economy. A simple diagram of a GVC for hi-tech industry is set out in Figure 3 below:

Figure 3: A Global Value Chain for the Hi-Tech Industry



source: http://www.edibasics.com/edi-by-industry/the-high-tech-industry/

Thus, there are important forward and backward linkages between and across GVCs. But, perhaps just as importantly are spillovers into domestically-based activities. These include adoption of process innovation to increase productivity; skills development and formation; quality standards, as well as being a source of demand for new activities.

It is these kind of interactions with GVC formation associated with targeted MATRIX sectors that is likely to be the agency of linking cuts in corporation tax to increased FDI. The links between GVCs and associated clusters, especially business and financial services are also likely to increase investment, growth and employment. The consequently widening of the tax base should then ensue. Northern Ireland has been noted for its success in the reform of local go ernment taxation. The important issue in respect of devolved corporate taxation is the transition arrangements and timing of these changes.

Leslie Budd: February 2015