Knowledge Exchange Seminar Series (KESS)

How Should NI Respond to Corporation Tax Cuts in ROI and GB?

The Fresh Start Agreement has committed the NI Executive to reducing the Corporation Tax Rate in Northern Ireland to 12.5% from 2018. The intention was to make the tax rate in Northern Ireland the same as in the Republic of Ireland, and lower than in Great Britain.

However, within the past year the Republic of Ireland has announced that a tax rate of just 6.25% will be applied to any profits associated with research and development[i], which many high technology firms will take advantage of.

Meanwhile, the British government has already promised to cut the GB corporation tax rate to 17%. If recent trends continue, the GB rate could fall even further, possibly even reaching 12.5% by 2025, completely nullifying any unique selling point which Northern Ireland has now earned. Plans have even been discussed by the current government to reduce Corporation Tax to 10% if the EU does not agree a free trade deal with the UK[ii].

However, as the cost of implementing tax cuts in NI depends on the GB rate, any reductions in Great Britain should be seen as bringing an opportunity for further reductions in Northern Ireland. According to the legislation which allows NI to set its own corporation tax levels, any rate can be set, even zero, and it can be reviewed annually[iii].

This research analyses what policy the NI Executive should pursue. It argues that simply maintaining the 12.5% rate, the default approach, would be the worst possible option. Matching cuts on an ad-hoc basis would be unlikely, and would be suboptimal even if it happened.

A much better approach would be to publicly commit now to match any cuts in the GB rate, reducing the NI rate to 11.5% by 2020, and possibly to 7% by 2025 if the GB rate is cut further.

An even better approach would be to commit to more than match any cuts in the main rate of corporation tax, but leave the small profits tax rate unchanged. This would allow NI to cut its top rate by 1.5% every time GB cut rates by 1%, which would make NI an extremely attractive destination for Foreign Direct Investment, raising productivity and incomes considerably.

Regardless of what approach is preferred, it would be extremely beneficial to agree on a strategy now, when there is a political consensus in support of corporation tax reductions. It would also enable corporations to make more informed decisions about the tax environment they are likely to face, encouraging them to commit to long-term investment within Northern Ireland.

Baseline Estimates of Cost and Additional Investment

As part of the Fresh Start Agreement, the NI Executive proposed cutting the corporation tax rate to 12.5%, under the assumption that the GB rate would be 19% in 2018 and 2019, and then 18% thereafter. Estimates for how much this would cost the NI Executive have been made for this paper, and are shown in Table 1. These estimates are based on the methodology used in a consultation document published by HM Treasury in 2011[iv], with figures updated to reflect the conditions prevailing when the Fresh Start Agreement was signed.

The starting point is to estimate how much Corporation Tax would be raised in Northern Ireland if the GB rates still applied. The direct effects of a cut in corporation tax from the GB rates can then be made. Reducing rates to 12.5% would mean NI corporation tax receipts would fall by just over 30% compared to if it simply maintained GB rates. There would then be several indirect effects which the NI Executive would also have to deal with. The first indirect effect is the cost of profit shifting by GB companies to NI. This would represent a cost to HMRC as the tax receipts earned from these companies would be reduced as they would pay the NI rate rather than the GB rate. This cost could be at least partially offset by the second indirect effect, whereby corporation tax receipts would be boosted by companies from the rest of the world who would now declare profits in NI. The third indirect effect would be that many sole traders and partnerships within NI would find it preferable to trade as a corporation, given that they would pay lower taxes, in a process referred to as Tax Motivated Incorporation. All of the figures are adjusted for the effects of inflation to express them in real terms, using 2016 price levels. The initial costs are lower to reflect that there may be a phasing in effect from profits being earned in one financial year, but the tax paid later.

The primary benefit of a corporation tax cut is that it should increase private sector investment, which will then stimulate production and create jobs. To calculate how much extra investment could be expected, the HM Treasury consultation paper of 2011[v] is again used, as it provides estimates for how much domestic and foreign direct investment could potentially increase by. The consultation paper notes that investment will rise over a ten year period but does not provide year by year estimates. This paper assumes that 95% of the increase would occur within the first five years, with small, steady growth thereafter. Given that investment is inherently forward looking, it is not just the current difference between the GB and NI rates which matters for investment decisions. In this paper, the expected average difference between the GB and NI rates over the subsequent five years is used to estimate the amount of additional investment that will occur.

Table 1: Estimated Costs if NI maintains rate of 12.5%, and GB does not cut rates

Year Ending	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Tax Rates (%)							
GB Rate	19	19	18	18	18	18	18
NI Rate	12.5	12.5	12.5	12.5	12.5	12.5	12.5
Expected Corporation Tax Raised if at GB Rate (£m)							
UK	45,421	42,140	42,418	43,267	44,132	45,014	45,915
NI	590	548	551	562	574	585	597
Loss as proportion of GB Rate	-34%	-34%	-31%	-31%	-31%	-31%	-31%
Loss to NI Executive from introducing NI Rate Due to: (£m)							
Direct Effects Loss	-67	-125	-168	-172	-175	-179	-182
Profit shift from Rest of World	12	23	20	20	20	20	20
Profit shift from GB	-17	-29	-22	-21	-19	-19	-19
Tax Motivated Incorporation	-11	-27	-32	-42	-46	-46	-46
Total	-83	-158	-203	-214	-221	-224	-228
Additional Investment (£m)	163	190	215	247	279	281	283

NI Strategic Responses

These cost estimates provide a baseline as to what the NI Executive agreed to in order to achieve a lower rate of Corporation Tax. However, the British government has already announced that the tax rate in 2020 will actually fall to 17%. It has not yet announced what will happen in the years after this, but it is very likely that the GB rate will fall further. If it continues to cut rates at the same pace as it has from 2010 to 2020, then it will likely arrive at a 12.5% rate by 2024-25.

How should the NI Executive respond? Four possible approaches are considered, as outlined below. A brief discussion is made about each option, before more detailed cost and investment estimates are provided.

Response A: Maintain the 12.5% Rate

The default option for the NI Executive is to simply maintain the 12.5% rate, regardless of what happens to the GB rate. If NI pursues this strategy it will save money compared to what had been planned in the Fresh Start Agreement.

The problem is that it will lose any competitive advantage over other regions. The costs of maintaining a 12.5% rate could easily be greater than the additional investment it attracts. The NI Executive will have to cover the cost of the temporary difference between the GB and NI rate.

However, corporations base their investment decisions on long-term costs and benefits. If they are aware that within a few years the NI rate will be very close to other GB regions, then a small temporary reduction will have little impact on attracting any additional Foreign Direct Investment.

Response B: Respond on an Ad-hoc Basis

It may be tempting to delay any discussion on future cuts until later, and hope to respond on an ad-hoc basis when GB cuts its rates further. However, this would almost certainly mean that only minor cuts, if any, would be approved. Under this arrangement it would be necessary to continually propose new cuts, possibly annually, each of which would have to be approved across the political spectrum.

In our calculations it is assumed that only a small reduction in the NI rate, to 11.5%, would be agreed, even though GB rates fell steadily to 12.5%. This would provide NI with a slight advantage over other GB regions, but it would be fairly minor. It may not even be factored in at all, as corporations would be uncertain as to if, or when, it would actually be implemented.

Response C: Commit to matching GB cuts

If Northern Ireland wants to maintain a competitive advantage over other regions, it needs to be able to maintain the differential in rates between NI and GB. This can easily be achieved, for almost no additional cost beyond what has been agreed to in the Fresh Start Agreement, as the cost to the NI Executive depends on the difference in rates between Northern Ireland and Great Britain.

Given the political consensus which currently exists in favour of lower corporation taxes, now would be the ideal time to commit to matching any GB cuts. It would provide a strong signal that Northern Ireland will always be the most attractive region to invest in, and would ensure that the additional investment which was hoped for under the Fresh Start agreement actually occurs.

If the GB rate is never cut then it will not have cost the NI Executive anything to have made this pre-commitment. However, if GB rates are cut, the knowledge that NI will always respond will provide a powerful incentive to corporations to choose NI for the long-term.

Response D: More than match GB cuts in the Main Rate

A final possibility is for the NI Executive to more than match any cuts made by GB in the main rate of corporation tax. This would be a bold approach which has the potential to transform Northern Ireland into a favoured location for Foreign Direct Investment.

The UK government has traditionally charged different corporation tax rates for firms earning more than £1.5m, called the main rate, and those earning less, who are charged at the small profits rate or receive marginal small profits relief. Historically, the main rate has been higher than the small profits rate, but it has been reduced in recent years so that they are now equal at 20%, with confirmed plans to reduce them both to 17% within the next few years. This cut in the main rate has largely been driven by the realisation that highly profitable firms are increasing mobile, and will be less willing to invest in countries where they face high taxes.

This paper suggests going even further, by reducing the main rate so that it is much lower than the small profits rate. Keeping the small profits rate at 12.5%, whilst aggressively reducing the main rate, would have a much more beneficial outcome in terms of Foreign Direct Investment, and would also mean less of a reduction in the block grant.

A change in the small profits tax rate will bring little benefit to the economy. It would be unrealistic to expect domestic Small and Medium Sized Enterprises to be able to innovate at a much greater rate simply because their after-tax profits had increased by about 5% (the net result of reducing the tax rate on their profits from 17% to 12.5%). An earlier consultation report by HM Treasury suggested that domestic firms would be responsible for only about a quarter of the potential increase in investment which would result from a cut to corporation tax[vi]. However, the direct costs would be high, as thousands of companies would pay less in taxes. It would also lead to an increase in tax motivated incorporation (TMI), where sole traders and small partnerships would find it cheaper to trade as a corporation.

The cost savings from not reducing the small profits tax rate could be used to make substantial cuts to the main rate of corporation tax. It would be feasible to reduce the main rate by at least 1.5% every time that GB reduced its rate by 1%. This would make Northern Ireland a much more attractive destination for Foreign Direct Investment. Multinational companies would be keen to make a serious investment in Northern Ireland if they knew that the high profits which they generated here were being taxed at a very low marginal rate, possibly as little as 4.25%.

Outcomes

A summary of the estimated costs and benefits for each strategy is outlined in Table 2. The figures show the scenario for the GB rate falling by about 1 percentage point per year, the rate at which it has been falling for about a decade, until it reaches 12.5% in 2024-25. The NI rate is changed depending on which strategic response is being analysed.

Estimates of the cost to the NI Executive, and the expected additional investment, are based on exactly the same methodology as used in the baseline. The predicted cuts in the GB rate will reduce the total amount of corporation tax raised in the UK, which will therefore reduce the direct effects cost to the NI Executive for any given tax rate. The additional profits which will be declared in NI, and the indirect effects of this on tax, are estimated from the HM Treasury consultation paper[vii].

The additional investment which will be made in NI is assumed to depend not just on the current difference between the GB and NI tax rates, but on the expected average difference over the next five years. This captures the forward looking nature of corporate decision making. It means that if the GB rate is expected to fall in the future, and the NI rate remains constant, the amount of additional investment is reduced.

The ratio between expected additional investment and costs are presented below. The Fresh Start Agreement which envisaged a constant GB rate, and an NI rate of 12.5% is expected to bring investment which is 1.24 times the cost. However, if the GB rate is cut and NI simply maintains the 12.5% rate, the amount of investment is substantially reduced, as corporations foresee that the advantages of moving to NI will be very short-term. Investment is predicted to be just 0.68 times the cost. An ad-hoc response is somewhat better, but investment will still be less than costs.

It is only by matching the GB cuts that the outcomes expected from the Fresh Start Agreement can be met. Under this approach the expected costs and additional investment are similar to what was initially hoped for, and investment would be about 1.22 times the cost. The benefits of aggressively cutting the main rate, but maintaining the small profits rate, would be even greater, with investment projected to be 1.68 times the cost.

Table 2: Summary of Estimates of Additional Investment, and Costs, of each Response

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	Total
Fresh Start Assumptions								
GB Rate (%)	19	19	18	18	18	18	18	
NI Rate (%)	12.5	12.5	12.5	12.5	12.5	12.5	12.5	
Investment (£m)	163	190	215	247	279	281	283	1,658
Cost (£m)	-83	-158	-203	-214	-221	-224	-228	-1,332
Ratio	1.95	1.21	1.06	1.15	1.26	1.25	1.24	1.24
GB cuts, NI maintain 12.5%								
GB Rate (%)	19	19	17	16	15	14	12.5	
NI Rate (%)	12.5	12.5	12.5	12.5	12.5	12.5	12.5	
Investment (£m)	130	123	94	67	41	15	0	470
Cost (£m)	-83	-158	-163	-132	-96	-57	0	-689
Ratio	1.55	0.78	0.58	0.51	0.42	0.27	0.00	0.68
GB cuts, NI respond ad-hoc								
GB Rate (%)	19	19	17	16	15	14	12.5	
NI Rate (%)	12.5	12.5	12.5	12.5	11.5	11.5	11.5	
Investment (£m)	135	137	117	103	91	66	51	702
Cost (£m)	-83	-158	-163	-132	-137	-98	-39	-810
Ratio	1.62	0.87	0.72	0.78	0.67	0.68	1.32	0.87
GB cuts, NI match cuts								
GB Rate (%)	19	19	17	16	15	14	12.5	
NI Rate (%)	12.5	12.5	11.5	10.5	9.5	8.5	7	
Investment (£m)	163	190	215	247	279	281	283	1,658
Cost (£m)	-83	-158	-205	-218	-225	-231	-236	-1,356
Ratio	1.95	1.21	1.05	1.14	1.24	1.22	1.20	1.22
GB cuts, NI more than match main rate cuts, but leave small profits rate unchanged								
GB Rate (%)	19	19	17	16	15	14	12.5	
NI Main Rate (%)	12.5	12.5	11	9.5	8	6.5	4.25	
NI Small Profits Rate (%)	12.5	12.5	12.5	12.5	12.5	12.5	12.5	
Investment (£m)	172	209	249	297	346	356	363	1,992
Cost (£m)	-83	-158	-190	-185	-173	-162	-144	-1,095
Ratio	2.06	1.32	1.31	1.61	2.00	2.20	2.52	1.82

Conclusion

Attracting high quality Foreign Direct Investment should be one of the top priorities of the NI Executive. Cutting corporation taxes to a rate of 12.5% should help achieve this goal. However, it needs to be appreciated that other regions are also cutting corporation taxes. If Great Britain continues to cut rates at the same pace as it has done, it may also reach a 12.5% rate by 2025.

Northern Ireland needs to choose how to respond. The lowest cost option would clearly be to always maintain the 12.5% rate. However, this would mean that NI will lose any competitive advantage which it has temporarily gained. There would be little incentive for foreign direct investment to choose NI compared to other regions of GB. If corporation tax is cut temporarily, but corporations expect GB to also cut rates soon, the cumulative increase in investment could actually be substantially less than the cost to the NI Executive.

Postponing the decision, in the hope of making ad-hoc cuts later, would almost certainly mean that few cuts will actually be implemented. If a commitment is not made now to match future cuts, when there is a political consensus behind the benefits of corporation tax reductions, it is unlikely that it will ever be achieved. This would also discourage investment, and again the costs may outweigh the benefits.

Committing to matching any cuts in the GB rate would be a clear signal that Northern Ireland will always offer the most attractive environment for Foreign Direct Investment, and give it a permanent advantage over other regions. It would cost almost nothing beyond what the NI Executive has already agreed to, as it would simply be maintaining the differential in rates between GB and NI. It would help to ensure that the amount of additional investment would exceed the projected costs to the NI Executive.

A bolder move for Northern Ireland would be to more than match any cuts to the main rate of corporation tax, but leave the small profits rate unchanged. The cost would actually be less than budgeted for under the Fresh Start Agreement. It would set Northern Ireland apart, giving it one of the lowest corporation tax rates in the world, and would signal that the NI Executive is willing to pursue innovative policies which will attract Foreign Direct Investment and create high value added employment.

What if we pre-commit to responding to GB tax cuts, but the GB rate does not fall? In this situation, the NI rate just remains the same as it is now, and there will be no cost. However, pre-commitment will still have a positive effect in attracting additional investment, as corporations will know that the tax advantages of basing in Northern Ireland will exist long-term. The NI Executive should pre-commit to matching further cuts now, whilst there is still a political consensus.

[i] The Telegraph, http://www.telegraph.co.uk/finance/budget/11929790/Ireland-slashes-corporation-tax-to-just-6.25pc-but-theres-a-catch.html
[ii] Daily Mail, http://www.dailymail.co.uk/news/article-3865430/Corporation-tax-HALVED-Brussels-blocks-free-trade-deal-Downing-Street-plans-cut-rate-10-nuclear-option.html
[iii] Corporation Tax (Northern Ireland) Act 2015 (http://services.parliament.uk/bills/2014-15/corporationtaxnorthernireland.html)
[iv] HM Treasury, Rebalancing the Northern Ireland Economy, p.25-29 (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81554/rebalancing_the_northern_ireland_economy_consultation.pdf)
[v] HM Treasury, Rebalancing the Northern Ireland Economy, p.23 (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81554/rebalancing_the_northern_ireland_economy_consultation.pdf)
[vi] HM Treasury, Rebalancing the Northern Ireland Economy, p. 23 (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81554/rebalancing_the_northern_ireland_economy_consultation.pdf)
[vii] HM Treasury, Rebalancing the Northern Ireland Economy, p.25-29 (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81554/rebalancing_the_northern_ireland_economy_consultation.pdf)