Corporate tax setting: the devolution of corporation tax

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Devolution of corporation tax setting

- *Rebalancing the Northern Ireland Economy* (March 2011) – discusses possible devolution of the power to set the corporation tax rate

- Devolution of corporate tax has been discussed before:
  - Varney Review (2007; Northern Ireland); Calman Commission (2009; Scotland); Holtham Commission (2010; Wales)
  - SNP (June 2011) proposed amendments to Scotland Bill

- Proposal:
  - allow devolved administrations to set a separate rate of corporation tax (no devolution of the tax base)
  - with responsibility for the revenue consequences (i.e. lower rate and lower revenue would mean lower public spending)
  - under EU State aid rules, government can’t set a rate that varies across the four nations – need to devolve tax rate setting power
Devolution corporation tax setting: motivation

• Key aim: boost private sector investment
  – particular concerns with respect to Northern Ireland (small private sector and border with Republic of Ireland)

• Output per head is notably lower in Northern Ireland and Wales than in either Scotland or England
  – lower private sector employment rate outside England
  – lower productivity in Northern Ireland and Wales

• Larger public sector outside England
  – public spending per head around £2,000 per head higher in Northern Ireland than in England
  – concerns that this may crowd out private sector activity
Why allow different corporate tax rates?

- General principle: benefits to a tax system that accounts for differences in responsiveness to tax
  - government policies to reduce tax on more mobile activities

- Investment likely to respond differently to tax in each nation
  - nations differ in their attractiveness for investment (e.g. benefits of being close to London)
  - some nations might be able to have a higher tax rate without deterring as much activity
  - may be more efficient to tax more responsive activities more lightly

- Would the effect on investment be sufficient to outweigh revenue loss (and associated spending cuts), the costs of administration (including policing avoidance) and the risk of tax competition?
A boost to investment ...  

• Many uncertainties around the effect of a lower rate of corporation tax on investment in each nation  
  – don’t know how responsive investment in each nation is to tax  
  – or exactly how much activity takes place in each nation currently  

• Treasury estimates of the effect in Northern Ireland:  
  – assume 12.5% rate introduced (RoI: 12.5%; UK: 26%-23%)  
  – domestic investment increases by £50-65 million in year 1 (approximately 2% of total investment in Northern Ireland)  
  – FDI from outside UK increases by £105-175 million in year 1 (+ £15–25m from GB).  
  – central estimate: total investment 6% higher each year
... but a reduction in revenues

• Treasury estimates of direct effect on Northern Ireland corporate tax revenues:
  – reduced by £270 million in year 5
  – (estimated 2009–10 corporate tax revenue was £465 million)

• Lower revenues would necessitate cuts in public spending
  – £270 million represents 2.3% of the 2010–11 departmental spending in Northern Ireland

• Revenues would likely be more volatile
  – Devolved administrations can’t currently borrow to smooth current spending
... and a relabelling of activities

• Taxing profits differently across the UK would distort behaviour and entail important efficiency costs
  – **profits shifting** (firms artificially moving profits to benefit from a lower rate)
  – **tax motivated incorporations** (increased incentive to incorporate - corporate tax rate lower than personal income tax rate)

• Revenue implications
  – direct effect on revenues in rest of UK
  – at least some of these will be borne by devolved administrations through a reduction in the block grant
Compelling reasons to maintain a single UK rate

- Administratively much simpler. Under devolution:
  - how to define where income should be taxed?
    - formula apportionment (calculate profit at the UK level)
    - separate accounting (calculate profit in each nation)
  - how to adjust the block grant?
    - reduce to reflect the size of corporate tax revenues + costs to the rest of the UK (e.g. costs of administrative or from firms shifting profits)
    - disagreements over the exact size of the adjustment

- Reduces the potential for harmful tax competition
  - a lower rate in one nation could incentivise other nations to lower their rate with a view to remain competitive
  - lower revenues for all
Conclusions

• We expect a decision on devolution of corporation tax rate to Northern Ireland in 2012
  – if devolved, seems likely that Wales and (especially) Scotland would want the option to follow suit

• Uncertainty over the size of the effect on investment and whether sufficient to outweigh revenue losses (and associated spending cuts) and administration costs

• Certain to increase complexity and compliance costs

• Implementing devolution would at best be a calculated risk, with unknown long-term consequences for the UK tax system