Submission to HM Treasury consultation on rebalancing the Northern Ireland economy

To: Mr. Mark Parkinson and Mr. Richard Williams at HM Treasury
cc: niconsultation@hmtreasury.gsi.gov.uk
From: The Bow Group Economic Policy Committee
Date: June 2011
Re: Rebalancing the Northern Ireland Economy

Rebalancing the Northern Irish economy

Consultation Response Format

This consultation response has been structured to provide an initial opening statement to complement the formal questions asked within the consultation. The consultations questions are answered in the order that they appear throughout the consultation paper. Some questions have been grouped together and answered collectively, for example question 3, answered as 3a and 3b. All references were last accessed on the 18th June 2011.

Opening Statement

The Bow Group believes that in economic terms, devolving the ability to set corporation tax rates to the Northern Ireland Executive (NIE) would be advantageous to the development of the Northern Ireland (NI) economy over the next 25 years and then beyond. Our reasons for this are provided within this consultation response.

However, the Bow Group believes it is also important to consider the constitutional implications of this consultation in parallel with the economic arguments. Since devolution in 1999, the differences in policy between constituent parts of the United Kingdom (UK) have increased. In some areas, this has been wholly positive as it has empowered local people and policymakers to take decisions closer to where the issues arise and the action is needed, rather than from Whitehall. In other areas however, it has led to “universal services” looking rather different throughout different parts of the UK. For example, in England, patients have to pay for their prescriptions in the NHS, whilst a policy of allowing both public and private sector providers has been developed to aid capacity and promote choice. In Wales, prescriptions are free and the NHS has turned its back on private sector involvement almost altogether. In Scotland, older patients can expect free personal care and eye tests, not available just south of the border in Berwick. In education, politicians have voted for tuition fees in England to rise to a £9000 ceiling, much higher than in other parts of the UK. In Scotland, Scottish born students have their fees paid by the taxpayer, but an English born student has to pay £1,820 per year to attend that same Scottish university. In NI, despite some coverage through the rates system, water charges are not passed onto the consumer as they are in England.

There are numerous other examples of the above, and with a nationalist government elected in Scotland, more divergence by design can be expected. Yet the fabric that binds the UK as a nation state together must be characterised by the similarities and fairness of opportunity that unite its citizens across its landmass, rather than differences that develop. Senior politicians across the political divide have warned of the dangers that uneven devolution could pose to the Union, including John Redwood MP[1] and former Prime Minister Gordon Brown MP, who has expounded the importance of shared values and fairness.[2] Examples can also be cited from overseas, where the Partido Popular of Spain have warned of further devolution of powers to regions such as Catalonia because of fears this may fuel increased separatist sentiments[3].

The Government must therefore consider the proposal of devolving corporation tax power to NI as much in these political terms as in economic terms. Devolution of corporation tax setting power to the NIE would constitute another substantial difference in a significant area of policy between one area of the UK and its other constituent parts. The Wilberforce Society suggests that, "If the devolved governments of Scotland and Wales also desired the power to set their own corporation tax rates, the same power should be given to them in the interests of equity and political coherence."[4] After the Scottish elections of 2011, First Minister Alex Salmond has already indicated he may wish to see further powers devolved, including corporation tax setting powers to Holyrood.[5,6] This would further enhance differences across the UK, and would create challenges for the Chancellor of the Exchequer in explaining to citizens in the North East of England or Wales for example, why they too should not benefit from distinct rates of corporation tax designed to galvanise their economies. The Government must also be mindful of unintended consequences. After a number of years of devolved corporation tax setting powers, what if the devolution of corporation tax is deemed not to be enough to rebalance the NI economy in the long-term, and local politicians, business and economists advise that further powers need to be devolved to provide NI with the economic arsenal to ensure such rebalancing can be realised? Would the Government – and the Chancellor of the Exchequer in particular - be prepared to countenance this, having set in train the policy of rebalancing?

Whilst we therefore believe in economic terms that a reduced rate of corporation tax would be beneficial to NI as explained below, we also believe the Government must consider the political implications of such a policy in relation to the long-term

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[1] http://www.johnredwoodsdiary.com/2007/10/27/the-treatment-of-scotland-and-england/
[2] http://news.bbc.co.uk/1/hi/uk_politics/6258089.stm
[3]http://www.opendemocracy.net/article/democracy_power/politics_protest/governance_of_spain_between_rock_and_hard_place
[4] Corporation Tax in Northern Ireland. TWS Special Report
[5] http://www.bbc.co.uk/news/uk-scotland-13498678
[6] http://www.heraldscotland.com/news/politics/control-of-borrowing-corporation-tax-and-the-seabed-salmond-s-key-demands-1.1101472

coherence and viability of the UK as a political union that has already witnessed some significant policy differences across its constituent parts, and that has on occasions already caused disgruntlement and debate amongst the electorate.

1) Whether there is a need to rebalance the Northern Ireland economy by strengthening the private sector over the longer term and to increase economic growth and promote significant new investment?

Yes. The consultation notes NI's strengths, which are important to highlight and are areas that must be built upon where possible. However, the consultation also notes that NI faces significant challenges, notably low GVA per capita, low productivity levels, relatively low levels of skills and relatively high levels of labour market inactivity.

One of NI's biggest challenges towards developing a truly dynamic and innovative economy is its huge reliance upon the public sector. The consultation highlights that over 30% of all jobs are within the public sector – higher than other parts of the UK – whilst the Economic Reform Group (ERG – a group consisting of economists, accountants and businessmen promoting a more competitive NI economy) suggest that the public sector accounts for up to 74% of GDP.[7] This was further highlighted by the findings in the Bow Group's *"The Enterprise Nation?"* paper from 2010. Compared to other smaller, wealth creating economies, such figures compare particularly badly. Government expenditure as a percentage of GDP in Singapore has been put at just 17%, Taiwan 18.5%, Switzerland at 32%, Estonia 39.9% and the Republic of Ireland at 42%.[8] The abovementioned figure for NI is unsustainable in the long-term, and renders NI more vulnerable than other regions of the UK to recessionary periods that necessitate reductions in public spending given this strong reliance on the public sector. It has also been noted that this sizeable public sector has the effect of "crowding out" the private sector, with the NI Executive noting that average public sector pay is £583.40 per week versus £456.80 per week.[9] This is a substantial difference that is likely to influence the career decisions of many talented individuals in the workforce, especially in an era of pay freezes and high inflation.

Whilst historical reasons have played their part in the preponderance of NI's public sector, the Province is now a different and more forward looking place relative to its nadir during "the troubles", although some security issues still remain, most notably witnessed during the disturbances in east Belfast on the 21st and 22nd on June 2011. A power sharing executive is now fully established, with Sinn Fein and the DUP sharing power, whilst a visit to the Republic of Ireland by Her Majesty The Queen in May 2011 proved just how far NI and wider Anglo-Irish relations have come. Given NI is more forward looking and the majority of its people share this vision and lament the notion of a return to the past troubles, it would seem appropriate that the economy is rebalanced with a greater and more vibrant wealth creating private sector.

Finally, the level of subvention received by NI from Westminster – that is, the difference between expenditure in NI versus tax receipts collected in the province, and accounted for by the UK exchequer – is large. The Varney Reports into the tax system and competitiveness of the Northern Irish economy put this deficit at £7

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[7] http://ergni.org/reports/report_corporation_tax_may_2010.pdf
[8] http://www.heritage.org/index/explore?view=by-variables
[9] http://www.dfpni.gov.uk/2010-11-pay-and-workforce-technical-annex.pdf

billion[10],[11] whilst the ERG put this at £9.3 billion[7]. This is again unsustainable in the long term for both NI and the wider UK taxpayer, and as such, the Northern Irish economy should aspire to be more self sufficient over the next 25 to 30 years.

2) Where there is most scope for increasing productivity, reducing labour market inactivity and increasing growth?

Developing a balanced economy constituting a vibrant, wealth creating private sector and a public sector that is responsive to reform and process innovation is the best way to promote increased productivity gains across the Northern Irish economy.

The Office for National Statistics (ONS) estimated that between 1997 and 2007, average public sector productivity fell 3.4%, at an annual rate of -0.3% per annum, whereas the private sector grew at a corresponding rate of 2.3% per annum.[12,13] Whilst the ONS noted in this report that it wasn't possible to measure output in some areas in NI, it follows that if these figures are in anyway mirrored in NI, productivity across the economy is likely to be pared back significantly given the preponderance of the public sector.

If the economy can be rebalanced and high productivity industries can be attracted to NI, such as financial and business services, technology and life sciences, then the overall productivity gains across the economy are likely to be more pronounced. This in turn will improve the chances of growth in NI.

However, policymakers – both at Stormont and Westminster – will have a role to play in promoting improved productivity, and the consultation paper touches upon. For example, The Bow Group's *"The Enterprise Nation?"* [14]paper highlighted from a range of political and business respondents that regulation can sometimes be prohibitive. Undue and overly onerous regulation can impact upon business starts ups, business expansions and on innovation. This is especially important in NI as business start up rates are relatively low and the number of young entrepreneurs is below that of the wider UK and Republic of Ireland[14]. If policymakers can create the regulatory conditions to enable a competitive environment to develop and businesses are able to be supported in adopting and leveraging technological and business innovation, then productivity is likely to increase.

Process innovation is also important across the public sector. We noted in *"The Enterprise Nation?"* that some law firms – not commonly associated with the sort of cutting edge innovations of a Google, Tesla or GSK – were able to yield revenue growth over their competitors where they were prepared to innovate, reform processes and amend practices. If this takes root across the public sector in NI productivity and efficiency is likely to increase.

Finally, the question mentions labour market inactivity, which is a particularly pronounced issue in NI. The Varney Report into tax policy suggested 29% of the working age population are not economically active, whilst 24% of households claim

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[10] Review of tax policy in Northern Ireland. Sir David Varney. 2007
[11] Review of the Competitiveness of Northern Ireland. Sir David Varney. 2008
[12] http://www.statistics.gov.uk/articles/nojournal/TotalPublicServiceFinalv5.pdf
[13] http://www.reform.co.uk/portals/0/Documents/Public%20Sector%20Productivity%20v2.pdf
[14] http://www.bowgroup.org/policy/economic

some form of incapacity benefit or disablement allowance (versus the UK average of 16%)[15]. Whilst there may be explainable reasons for these figures, they appear at face value to be unsustainably high and the Government's Work Programme and medical assessment programme for incapacity benefit claimants (Work Capability Assessments) should be an important policy in addressing this.

- **3a) As part of consultation, the Government would welcome views on the importance of the headline corporation tax rate in encouraging investment?**

- **3b) As part of consultation, the Government would welcome views on the extent to which a reduction in the rate of corporation tax in Northern Ireland could support additional investment, higher growth rates and increased employment in the Northern Ireland economy?**

It is the view of the Bow Group that corporation tax is an important component in encouraging both local and Foreign Direct Investment (FDI). *"The Enterprise Nation?"* paper extensively covers the importance of corporation tax from a range of different respondents, almost all of whom were of the opinion that a lower rate of corporation tax is beneficial in general, and would be beneficial to NI specifically. Indeed, the Republic of Ireland has famously had a corporation tax rate of 12.5% and which has been lauded for its ability to attract inward investment of high tech, high productivity industries and has been preciously protected by Irish negotiators during their bailout talks with the EU and IMF. There also appears to be cross party consensus in NI that a corporation tax rate reduced to 12.5% is something that would be advantageous to NI.

Devereux and Lockwood have produced research highlighting how reductions in corporation tax can aid FDI, whilst the ERG are steadfast in their belief that a lower corporation tax for NI is necessary to develop the economy.[14] The Centre for Economics and Business Research (CEBR) also looked at corporation tax for the Taxpayers' Alliance and concluded that if corporation tax in the UK were reduced by 2% per year to 12.5%, then by 2021 GDP would be 8.7% higher, with total fixed investment nearly 61% higher and total employment 8.7% higher.[16] The CBI states that a low corporation tax rate is vital for the UK to remain competitive.[17] Specific to NI, the Economic Advisory Group (EAG) believe that growth, productivity, FDI, employment and standard of living would all increase by 2030 if corporation tax in NI was reduced to 12.5% based on their assumptions.[18]

However, Varney noted in his reports that there would be difficulties associated with any corporation tax reduction, and that it would not be a silver bullet that could transform the NI economy. *"The Enterprise Nation?"* highlighted how regulation, education, skills, infrastructure development, labour costs, culture and transport links are all equally important in efforts to rebalance the NI economy. If the skills, infrastructure and so forth aren't available, a company will find it difficult to invest in a

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[15] Office for National Statistics, 'Regional Trends', latest data. These benefits include Incapacity benefit, disability living allowance, severe disablement allowance, disabled persons tax credit, industrial injuries disablement benefit, war disablement pension.

[16] M. Taylor, M. Sinclair & C. Taylor. How Cutting Corporation Tax Would Boost Revenue.
[17] http://ukaapti.cbi.org.uk/media/19112/making-the-uk-the-best-place-to-invest-summary-report-for-web.pdf
[18] http://www.eagni.com/fs/doc/publications/impact-of-corporation-tax-on-ni-eag-report-final-report.pdf

country irrespective of its headline corporation tax rate. For example, Dell recently vacated the Republic of Ireland for Poland, despite having a higher corporation tax rate of 19%.[19] In the Cushman and Wakefield European Cities Monitor (ECM) 2010, the top four factors of importance in determining where a business may locate were ease of access to markets, customers or clients; availability of quality staff; quality of telecommunications; and transport links with other international cities. [20] London was top rated in 7 of the 12 major rankings, which also includes languages spoken, whilst Dublin ranked top for climate for business created by government.

One smaller, lower profile example relative to something more obvious such as skills would relate to transport. *The Enterprise Nation?* paper discussed the importance of developing transport links with the Republic of Ireland, to the UK mainland – especially the City of London - and to other international markets from Belfast. Yet in relation to the latter point in particular, the Republic of Ireland has reduced Air Passenger Duty (APD) for departing passengers from €10 to €3, whereas in the UK long haul APD has increased by around 30% to £120 and £60 for business and economy tickets respectively. This could have the effect of encouraging airlines to favour the Republic of Ireland as opposed to NI, especially given good road links between Dublin and NI, and will be one of a multitude of factors – large and small - in attracting FDI.

It is also important to note that whilst other factors described above are very important in attracting investment, in terms of *tax*, the corporation tax rate isn't the only important aspect; the *tax base* is also extremely important, namely what constitutes taxable profits in the first place. This is important as tax base multiplied by tax rate determines tax collected by the state, or tax paid by the business. Like for like comparisons with the Republic of Ireland on assumptions that NI would also have a 12.5% corporation tax rate are therefore not always appropriate as different allowances and deductions exist between the Republic of Ireland and the UK, which would effect NI unless it were to become independent of the UK for tax purposes. Equally, treatment of profit-shifting, transfer pricing, rules determining thin capitalisation, international tax treaties, indirect taxes and so forth are treated differently between the Republic of Ireland and the UK. These areas also have an impact on investment for companies over and above the headline corporation tax rate.

In principle therefore, a reduced rate of corporation tax for NI could help attract investment, growth and employment, it is not the only factor. Consideration of the tax base, indirect taxes, infrastructure, skills and education, transport policy, energy prices and so forth are also critically important as a collective package designed to attract investment.

- **4a) As part of consultation, the Government would welcome views on the estimated costs arising from a lower corporation tax rate in Northern Ireland?**

- **4b) As part of consultation, the Government would welcome views on the dynamic impacts on tax receipts arising from a lower corporation tax rate in Northern Ireland?**

[19] http://www.ft.com/cms/s/0/71fe109a-ddf0-11dd-87dc-000077b07658.html#axzz1OLc9yRq1
[20] http://www.europeancitiesmonitor.eu/wp-content/uploads/2010/10/ECM-2010-Full-Version.pdf

The Bow Group has not conducted any independent economic analyses on the costs that may arise from a lower rate of corporation tax in NI. Various estimates have been made as to what the reduction in Northern Ireland's Block Grant should be. Varney's suggested an up-front cost of £300 million per annum with a cumulative cost to the Northern Ireland Assembly of £1 billion over 10 years, whilst the cost to the UK Exchequer would be £2.2 billion over 10 years.[10] The ERG however suggest that within 20 years the UK subvention to NI would be reduced by £1 billion as a result of such a policy. [7]

However, the Bow Group believes that any reduction in NI's rate of corporation tax must be accompanied by a fair reduction in the NI block grant calculated with independent economic, business and academic experts. This is because many other regions of the UK, such as the North East and Wales, could make legitimate claims for their own corporation tax rate reduction to reinvigorate their local economies. If this is not to be granted to these regions, then they - and the wider UK taxpayer - must be compensated fairly through the block grant for the potential benefits NI could receive from a corporation tax reduction. Regions such as the North East and Wales already face significant economic challenges and these would likely intensify further if NI became more attractive and competitive through a more favourable rate of corporation tax, meaning that in the spirit of the coalition's drive to promote "fairness", further investment in these regions would be required. This is not also exclusively applicable to more laggard economic regions of the UK. As the ERG states:

"Northern Ireland's dependence on taxes raised elsewhere is merely the most extreme example of a wider problem of an unbalanced UK economy. The three regions of South East England subsidise almost all other regions, and NI most of all. Without this outflow of tax revenues these three southern regions would collectively be better off every year by the huge sum of £42 billion. This would be enough to pay for thousands of miles of new motorway each year, as well as paying for many other public projects in these highly congested regions."

This statement is important as if NI is to benefit from a policy that would reduce the rate of corporation tax, other regions that have been subsidising NI need to benefit from the reduction in block grant to further increase their investment opportunities and prospects for citizens in these regions.

A final point regarding dynamic tax receipts relates to profit shifting. Varney and others have identified that profit shifting from the rest of the UK to NI could occur. Varney stated:

"In contrast to attracting cross-border investment, the capturing of profits by a tax jurisdiction may contribute to its exchequer, but it would not generally contribute to the type of knowledge transfer, technological progress and high value production that is associated with sustainable high skilled job creation, labour productivity and long-term economic growth."[10]

This is a valid point to raise as profits can be shifted with greater ease – particularly in today's interconnected world – than capital investment, which tends to bring with it employment, production and wider economic growth from increased consumption. If UK firms shifted profits to NI then there would be some risk that the UK Exchequer would see a reduction in revenues; NI may not experience corresponding investment and employment improvements either; and other UK regions see economic destabilisation as a result.

5) As part of consultation, the Government would welcome views on the risks to the Northern Ireland Executive arising from a devolved corporation tax rate in Northern Ireland.

The most overt risk for the NIE arising from a devolved corporation tax would be that the new and lower corporation tax rate does not yield as much investment as economically modelled and projected, leaving NI with less investment, less revenue generated from their corporation tax rate and therefore needing to make up the deficit from their existing (but decreased) block grant. This in turn could have implications for public spending, services and employment.

Additionally, the issue of profit shifting and transfer pricing is touched on above, yet the consultation in section 4.46 suggests that any risk associated with such activity would lie with the NIE. Of course, if such profit shifting occurred from non-UK countries to a substantive degree then the NIE could benefit from such movements.

The other risks identified in the consultation are also valid and need to be factored in calculations made by the NIE and UK Government before any devolution of corporation tax is made. These include the impact of global slowdowns and recessions on corporation tax receipts, decisions that may lead to disinvestment in NI and whether the skills, infrastructure, transport links and so forth are available for job creating FDI to occur in NI, the importance of which is highlight in the ECM 2010 and *The Enterprise Nation?.* Without making any analogy, Bosnia has a corporation tax of 10%, but for a raft of reasons, is not a prime location of choice for large amounts of businesses. On the reverse side of this coin, Dell recently vacated the Republic of Ireland for Poland, despite having a higher corporation tax rate of 19% than the Republic of Ireland.

A final risk would be that that the level of sectarian violence increases on a more sustained and consistent basis, thereby tarnishing NI's image overseas and resulting in lower levels of confidence in those who would otherwise be willing to invest in NI.

As the consultation makes clear, there will always be a risk associated with this type of proposal, but the NIE and all other parties lobbying for a devolved corporation tax must weigh risk of pushing forward versus the risk of doing nothing given the current state of the NI economy. However, it would be unfair on citizens and businesses on the UK mainland if NI reaped the benefits from a successful implementation of a devolved corporation tax policy, yet looked to abdicate responsibility to any perceived Westminster safety net if such as policy did not manifest as hoped. Whether this latter point could practically happen as a result of the Azores ruling is questionable however.

6) As part of consultation, the Government would welcome views on potential compliance costs and administrative burdens for business arising from a devolved corporation tax rate in Northern Ireland

The administrative burden of a devolved corporation tax has the potential to be reasonably significant, although the Bow Group has not independently modelled such potential costs.

HMRC would likely have to administer the new corporation tax collection system for NI, with reciprocal employment required at the NIE. Given that it is proposed that the

NIE has tax varying powers, reconciliations between projected revenue and outturn receipts would be required, which could very well prove to be complex, requiring further administrative resource. Business would likely also experience an additional administrative burden as they would be required to calculate and justify which segments of their profits are subject to the NI corporation tax rate and the UK corporation tax rate respectively. However, for larger, multi-national organisations this cost may be limited as profits derived across the globe already require tax specialists to be employed to interpret such regulations. For other companies, such a cost may be worthwhile paying if their overall profits are increased by their income being taxed at an NI rate of corporation tax that is lower than the UK rate (or where they were previously domiciled for tax purposes). The view of business is therefore of obvious importance when considering this question.

The previously mentioned issue of profit shifting and transfer pricing would *potentially* require additional legislation, which would in turn require an additional administrative capacity to manage and "police". As such, this would require job creation in the civil service at a time when Government is looking to implement budgetary reductions across most Whitehall departments.

7) As part of consultation, the Government would welcome views on the approach that would be taken to adjust the block grant arising from a devolved corporation tax rate in Northern Ireland?

The Bow Group has not analysed what reductions in the NI block grant could be expected as a consequence of devolving corporation tax setting powers to the NIE, and this requires further detailed analysis by the Treasury, the OBR and independent academics and economists. However, the Bow Group believes in principle that tax varying powers for the NIE would be the most appropriate policy if devolving corporation tax to the NIE were countenanced by the Government. This would include the NIE agreeing with the Treasury the initial rate of corporation tax and then having subsequent power to vary upwards or downwards in response to advice from business, global economic conditions and local political considerations. However, as the consultation states, this would require reconciliations between planned and outturn receipts, which would potentially increase administrative costs (see Q6). The Bow Group also believes that whilst NI should be able to benefit from the potential upside that a devolved corporation tax may bring – an upside which would be good for the province and the UK as would help rebalance the UK economy to some degree away from London and the South East – NI policy makers must also take accountability for any downside that may materialise. This is an important approach given other regions of the UK could make a case for a devolved rate of the corporation tax and so will require other forms of economic stimulation to develop and rebalance their local economies.

8) As part of consultation, the Government would welcome views on the balance of potential costs and benefits of a reduced corporation tax rate in Northern Ireland.

In addition to the responses outlined in this paper, the Bow Group believes that the list of pros and cons outlined by the consultation paper in table 4F are a reasonable reflection of the primary issues that need to be considered when considering this policy proposal.

It is likely that from NI's perspective, the economic benefits would outweigh the risks. However, as described in this response and in the consultation paper itself, the risks are not altogether insignificant. Because of the Azores ruling and how this is likely to be interpreted at EU level in this scenario, and because of need to apply principles of fairness to other UK regions, the NIE would have to bear the burden of corporation tax revenues yielding less revenue than forecast. This in turn would impact public spending decisions and potentially employment in the public sector. If spending were to be reduced in the areas required to attract FDI as outlined in *The Enterprise Nation*[14] - and outlined in Q3 - to account for this shortfall, then a self-defeating cycle would ensue. Given the NIEs reluctance to introduce water charges as an example – currently only supported by The Alliance Party[21] out of the mainstream parties – making tough decisions that would protect areas of investment designed to attract FDI and rebalance the NI economy over a medium to long-term period over potentially impacting employment or quality in the public sector in the short term does not augur well. In addition, because of the initial reduction in the NI block grant and the time it would take for investment – and subsequent revenues – to embed as a consequence of a lower rate of corporation tax, short term fiscal pressures could occur.

However, the upside is relatively clear. The chances of greater investment – both local and FDI – is likely to be enhanced as a result of devolving corporation tax to the NIE. In addition, any rebalancing of the NI economy has to be viewed over the period of 20 or even 30 years. Over this time period, it is estimated by the ERG that a larger private sector with up to 90,000 new jobs at higher salaries would be created, thus improving standard of living, consumption and ultimately growth in the NI economy would result.

Risks are also likely to be cyclical, with periods of economic growth and stability producing potential for greater investment and corporate profits, but periods of recession seeing potential disinvestment and lower levels of revenue collected. However, as stated in Q5, such risks ultimately have to be weighed against the risks (and prospects) of doing nothing.

From the UKs perspective, we consider the risks are likely to be higher. Estimating, legislating, administering and policing intra-UK profit shifting and transfer pricing will likely be difficult and incur some cost. Varney commented that around 50% of the UK tax base is theoretically mobile, so profit shifting and relocation of business from regions of the UK that also require private sector investment is a clear risk. The ERG, who are bullish on the proposal to devolve corporation tax to NI, suggest that it may take 20 years for the UK subvention to NI to be reduced by £1 billion as a result of such a policy.[7] This may be considered too low a figure given the size of saving relative to the time and risk inherent to the policy, although the ERG also forecast that because of the additional income tax, VAT etc…generated from the increased local and inward investment a lower corporation tax rate, the Treasury would be a net gainer of revenue after just 6 years.

- **9a) As part of consultation, the Government would welcome views on the merits of a deferred implementation of a rate reduction in Northern Ireland and its potential impact on investment decisions?**

- **9b) As part of consultation, the Government would welcome views on the extent to which a phased reduction in the rate of corporation tax in**

[21] http://www.cain.ulst.ac.uk/issues/politics/docs/apni/apni_2011-05-05_nia_man.pdf

Northern Ireland could support a rebalancing of the economy while allowing the costs of the reduction to be more effectively managed.

An announcement a number of years in advance of an actual corporation tax reduction – should such powers be granted to the NIE – would appear to have merit. Signalling to business an intention to cut corporation tax can be very important, especially if this signal is credible and backed by a solid and agreed timetable for implementation.[22] Indeed, after the Chancellor of the Exchequer announced that UK corporation tax would be reduced incrementally throughout the course of this parliament, large firms such as WPP suggested they may relocate to the UK as a result.[23] As the consultation also states, such a deferral would provide time to iron out practical issues such as determining the precise reduction in NI's block grant, the administrative capabilities required and the public spending reductions required in NI.

In terms of a phased reduction, the advantages highlighted in the consultation paper are ones the Bow Group would agree with. Easing the pressure on the reduction incurred to the block grant is likely to be particularly important in the aftermath of the effects of the "credit crunch" in NI, and thus a phased approach could help mitigate this. However, the danger associated with a phased approach is that unforeseen political or economic events occur before corporation tax is reduced to its final target rate, and politicians decide to change course. Therefore politicians would have to be fully committed to completion of full corporation tax reduction to the announced endpoint irrespective of unexpected events to avoid badly damaging business confidence in NI.

Should Invest NI, the NIE and other related bodies in NI determine that further investment is required in addition to the corporation tax rate reducing in order to attract companies inwards, such decisions could be made more readily under a phased approach given the greater level of capital remaining in the block grant, which would be another advantage. Finally, most parties lobbying for a reduced level of corporation tax do not seem to be necessarily wedded to the 12.5% rate, but merely use this as an illustrative example. Practically, this would be a likely end rate given the Republic of Ireland's rate is also 12.5%.

Ultimately, should the Government decide to go ahead with devolving corporation tax setting powers to NIE, detailed discussions as to whether a phased reduction or "big bang" approach to an immediate rate of 12.5% will be required with the NIE and all mainstream political parties in NI as it will be local politicians who will have to ultimately justify such decisions to their local electorates, and in a phased approach, hold firm to enable corporation tax to be reduced on a sliding scale to the announced end rate.

10) As part of consultation, the Government would welcome views on the impact that restricting any reduction in corporation tax receipts to trading income only would have on the aim of rebalancing the Northern Ireland economy and the value for money of a corporation tax reduction.

The aim of any corporation tax reduction to NI must ultimately be to see greater investment – both local and FDI – and increased genuine trading profits, as opposed

[22] http://www.telegraph.co.uk/finance/budget/8402485/Budget-2011-Surprise-cut-in-corporation-tax-will-stimulate-growth.html
[23] http://www.bbc.co.uk/news/business-12844986

to practices such as profit shifting and transfer pricing, that aim to reduce company tax bills. However, this may be more difficult to distinguish in reality than in theory as noted by this consultation with additional “policing costs” and administrative burdens associated with this likely to ensure misuse of a lower rate of corporation tax in NI for tax limitation reasons does not occur outside of genuine trading profit generation. So long as risk of unintended consequences and administrative burdens were deemed manageable, introducing an NI rate of corporation tax specific to trading profits would in this sense provide parity with the Republic of Ireland on this parameter, which is one of the main arguments for reducing corporation tax in NI.

- **11a) As part of consultation, the Government would welcome views on whether there are other options to offset the cost to the NIE of a reduction in the rate of corporation tax that would be consistent with the overall aim of rebalancing the Northern Ireland economy.**

- **11b) As part of consultation, the Government would welcome views on extent to which changes to R&D tax credits, annual investment allowance, training credits or a national insurance holiday could provide feasible, effective, affordable and value for money support for the rebalancing of the Northern Ireland economy.**

The Bow Group believes that in principle, the devolution of corporation tax setting powers to NI is likely to be beneficial for growing the private sector and thus rebalancing the NI economy. However, we believe that any off-setting of the cost to the NIE should not just be consistent with the aim of rebalancing the economy, but should equally consider the impact on other regions of the UK that are also in need of economic growth and rebalancing.

Most of the additional measures highlighted are likely to be beneficial to some degree and should be utilised where possible. *The Enterprise Nation* paper published by the Bow Group highlights views around the impact of tax credits for example, from respondents including Bertie Ahern. The consultation acknowledges that many of these proposals may constitute State Aid, and thus may confront similar issues to those presented by the Azores ruling. Given the potential for increased administrative – and potential legislative – costs and burdens imposed by any prospective devolution of corporation tax to NI for the NIE, HM Treasury and business, caution must be exercised when considering extension of policies pertaining to tax credits, national insurance holidays, AIA and so forth.

For extension of such policies to be realised, greater fiscal autonomy in these areas may need to be granted to the NIE. It should be noted therefore that this would obviously further increase divergence between NI and the other constituent parts of the UK. Some substantive differences in policy across the UK have emerged as a result of devolution since 1999. Scotland is currently governed by a Nationalist Government with a recently enhanced electoral mandate that is openly looking to forge an increasingly distinct identity for Scotland. The Government should consider the political impact on the Union of further significant differences in policy that could occur as a result of further substantive devolutions of power, in this case fiscal autonomy to NI. For the Union to remain sustainable there must be enough similarities and shared macro-policies that bind constituent parts of the Union together, with increasing divergence creating the possibility that at some point in the future, electorates may believe differences are great enough for a majority to no longer believe in the purpose or value of the Union. Therefore potential political implications for the Union are the reverse side of a same coin that also promotes economic benefits for NI through devolution of power in this area.

12) In relation to other economic reforms in Northern Ireland discussed in this report, bearing in mind the devolved nature of many of these policies, the Government would welcome views on how far:

- **Welfare reform has the potential to reduce economic inactivity in Northern Ireland and increase economic growth;**
- **There are lessons to be learned and policy proposals from the recent Sub-national Growth White Paper that are transferable to Northern Ireland. If so which ones?**
- **Devolved policies have an important role in rebalancing the Northern Ireland economy.**

➢ As already mentioned in question 2, the Bow Group believes that welfare reform and the Government's Work Programme have a potentially important role to play in reducing economic inactivity in Northern Ireland. As noted, the Varney Report into tax policy suggested 29% of the working age population are not economically active, whilst 24% of households claim some form of incapacity benefit or disablement allowance (versus the UK average of 16%)[24]. In addition, recent ONS figures show the number of households in Northern Ireland where no one has ever worked stand at 12,000, or 2.1%, higher than most other UK regions.[25] Whilst there may be explainable reasons for these figures, they nevertheless appear to be unsustainably high and the Government's Work Programme and Work Capability Assessment initiative for incapacity benefit claimants should be an important policy in addressing this.

➢ The Bow Group believes that whilst potentially painful, at a UK level, the Government's deficit reduction measures are necessary to achieve sustainable, long-term benefits to the UK economy. In June 2010 the OBR stated that the Coalition Government inherited a deficit of 10.5% of GDP, with the structural deficit at 8% of GDP.[26] These numbers are unsustainable. Macroeconomic stability is essential to ensure that businesses have the confidence to invest in the UK and that the markets have confidence in the UKs finances to lend at a low and sustainable rate of interest. Countries such as Greece, Ireland, Portugal and Spain have all failed to fully secure the confidence of the bond markets, with the resultant bailouts required for three of the aforementioned nations and rising yields – meaning more punitive borrowing rates – for the fourth. The Coalition Government's strategy has been supported by the CBI[27,28] and more recently, the IMF, amongst others[29]. The UK AAA credit rating retained by all of the major credit rating agencies. This is as beneficial to NI as it is to the wider UK.

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[24] Office for National Statistics, 'Regional Trends', latest data. These benefits include Incapacity benefit, disability living allowance, severe disablement allowance, disabled persons tax credit, industrial injuries disablement benefit, war disablement pension.
[25] http://www.statistics.gov.uk/downloads/theme_labour/worklessness/hhldsneverworked.xls
[26] http://budgetresponsibility.independent.gov.uk/wordpress/docs/junebudget_annexc.pdf
[27] http://www.cbi.org.uk/pdf/20110518-cbi-helen-alexander-annual-dinner-speech.pdf
[28] http://www.cityam.com/news-and-analysis/cbi-rallies-behind-plan-calls-pro-growth-agenda
[29] http://www.imf.org/external/np/ms/2011/060611.htm

- The Bow Group believes there are a number of proposals in the Sub-national White Paper that could be utilised through some of the devolved powers held by the NIE. As mentioned in Q3, whilst we agree that lower rates of corporation tax are favourable towards triggering increased levels of investment, NI can not rebalance its economy with this alone. NI needs to ensure that it has the correct education and training courses available in public, private and business sectors to produce the skills that businesses require, and at the level of quality that gives business confidence that it can optimise its operations through this skills base. Effective planning regulations and manageable levels of bureaucracy can be important considerations for certain types of businesses looking to start up or expand. Constructive and coherent relationships between local authorities and businesses can help identify and then develop the correct conditions for investment. High quality infrastructure – both technical and transport – is critical in enabling businesses to efficiently engage with their customers, partners, supply chains and international markets. Cultural development is important but often under-looked, as locations need to be desirable to live in to attract sought after and internationally mobile high quality staff. With tourism identified by most major political parties in Northern Ireland as an area which can be developed and grown, the removal of divisive policies and events that can lead to disruption and violence, thus tarnishing NI's image abroad, could help to swell the number of tourists visiting the province. Indeed, Varney suggested that Northern Ireland boasted 40% of all out of state visitors to the island of Ireland before the troubles, a figure that currently stands at just 20%.[10] Implementing reforms and imbuing innovation and efficiency within the public sector can help to increase productivity levels, and therefore precipitate better value for money from Block Grant expenditure.

  All of these areas identified are areas that can be fully or partially influenced by devolved policy makers in the NIE and are vital in ensuring the sustainable development of the NI economy.

ENDS

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