

Explanatory Note on estimating the cost of a reduction in the Corporation Tax rate in Scotland

Summary

Measure description

1. Reduction in the Corporation Tax (CT) rate in Scotland for onshore companies.

Key estimates

2. This paper presents provisional estimates of the cost of the option for the main rate and small profits rate of CT in Scotland to be cut to 12.5% from April 2011. The following costings are based on the HMRC Knowledge Analysis and Intelligence (KAI) costing models for the UK-wide main rate CT changes and the small profits rate CT changes. These costing models have been approved by the Office for Budget Responsibility (OBR) for use on UK wide changes. Were any proposals to be taken forward, the provisional figures in this note would be subjected to refinement based on more detailed analysis and would need OBR approval.
3. The estimates also include the net revenue effects from an expected increase in Tax-Motivated Incorporation (TMI) across the following regimes: Self Assessment, PAYE Income Tax, Class 1 Employee & Employer NICs, Class 2 & 4 NICs and CT. The TMI effects are derived from a separate KAI costing model but again are part of the standard methodology for costing UK wide changes. In addition, estimates of the costs of the following other effects have been produced: the impact on receipts relating to the assurance and insurance sector; the additional impact of other large Scottish domiciled companies. More details on these additional impacts are given later in the note in paragraph 25.
4. The estimates are shown in table 1 below; this is followed by details of the methodology.

Table 1: Cost to the UK Exchequer of a reduction in the CT main and small profits rates applying in Scotland to 12.5% (7.0% UK tax base assumption)

£ millions (National Accounts Basis, rounded to nearest £5 million)	2011-12	2012-13	2013-14	2014-15	2015-16
Direct effect:					
a) Main rate	-500	-850	-855	-840	-845
b) Small profits	-5	-200	-285	-310	-330
c) Marginal Small Profits Rate	0	-55	-75	-75	-75
Branches (lower estimate)	-170	-290	-290	-285	-290
Branches (upper estimate)	-315	-540	-545	-530	-535
Behaviour:					
a) Rest of the World (non-UK) to Scotland with branches lower estimate	125	235	240	220	215
with branches upper estimate	150	285	295	270	260
b) Rest of UK to Scotland with branches lower estimate	-245	-470	-480	-440	-425
with branches upper estimate	-300	-570	-590	-540	-520
c) Tax Motivated Incorporations	-15	-35	-55	-70	-85
Total (lower estimate)	-815	-1,660	-1,800	-1,795	-1,835
Total (upper estimate)	-985	-1,965	-2,105	-2,090	-2,130
Other possible impacts					
a) Assurance and Insurance	-105	-135	-135	-135	-135
b) Other Large Scottish Domiciled groups	-330	-440	-440	-440	-440
Total with other possible impacts (lower estimate)	-1,250	-2,245	-2,385	-2,380	-2,420
Total with other possible impacts (upper estimate)	-1,420	-2,550	-2,690	-2,675	-2,715

Note: due to rounding some figures may not sum exactly

Introduction

5. This note sets out the methodology and key assumptions used to produce the latest costings. It is divided into:

- Section A explains how the tax bases have been estimated;
- Section B sets the calculation of the static (pre-behavioural) yield;
- Section C sets the calculation of the post-behavioural yield;
- Section D flags the issues of second round effects.

A - Establishing the tax base

Main rate

6. Estimates of UK onshore CT accruals relating to companies paying the main rate of CT are taken directly from the UK CT forecast for the quarterly instalment payments of non-life companies. This forecast is calibrated to an estimate of 2010-11 accruals based on latest tax

receipts, and then projected in line with the economic determinants underlying the forecasts in the OBR March 2011 Economic and Fiscal Outlook. It excludes UK oil and gas revenues.

7. The CT accruals base used also takes account of the estimated effect of the March 2011 Budget corporate tax rate changes. Thus the underlying CT main rate used is 26% in 2011-12, 25% in 2012-13, 24% in 2013-14 and 23% in 2014-15; while the small companies rate is 20% in 2011-12 and subsequent years.

8. The proportion of onshore UK CT receipts which relate to Scotland is estimated to be 7%. The methodology used in deriving this proportion is consistent with the estimates of the cost of a CT rate change in Northern Ireland published in the HM Treasury Consultation document, *Rebalancing the Northern Ireland economy*¹. Companies whose registered address has a Scottish post code, excluding UK oil and gas companies, have been identified, and the total CT accrual from these companies has been calculated. Estimates have been produced in this way for 2004-05 to 2008-09. Across these years, Scottish registered companies make up around 7 per cent of total UK onshore CT accruals. This proportion is applied to the UK main rate CT accrual (as described in the preceding paragraphs) to arrive at an estimate for main rate onshore CT accruals relating to Scotland.

9. Separate analysis by the Scottish Government and based on ONS Regional Accounts (see 'Government Expenditure and Revenue Scotland 2009-2010', published 22 June 2011) produces an average estimate of 8.6% across the years 2005-06 to 2009-10 as the Scottish share of onshore CT receipts (see paragraph 12 and 13 and the discussion of branches).

Small profits / Marginal small profits rates

10. To estimate the size of the tax base over the costings period, the tax base is assumed to grow in line with the OBR forecast of CT accruals from companies which do not pay by quarterly instalments. This forecast is calibrated to an estimate of 2009-10 accruals based on latest tax receipts and then projected in line with economic determinants from the March 2011 Budget economic forecasts. The forecast is then apportioned between companies according to whether their profits are taxable at the small profits rate or the marginal small profits rate. In line with the assumption that 7% of the CT tax base pertains to Scotland used for the main rate, this proportion is also applied to the small profits and marginal small profits rates tax bases to arrive at figures for Scotland.

B - Estimating the static (pre-behavioural) yield

11. The pre-behavioural Exchequer cost for main rate and small profits rate is calculated by applying the pre and post measure tax regimes to the tax bases described above. Reducing the rate to 12.5% in Scotland incurs a direct (pre-behavioural) annual cost by the end of the

¹ See: http://www.hm-treasury.gov.uk/consult_rebalancing_ni_economy.htm

forecast period of £1,250m (excluding branches), and a further cost between £290m and £545m for branches, though—given the preliminary nature of these estimates—these estimates could be subject to change.

Companies with operations crossing the Scottish border

12. A provisional range has been estimated for the direct impact on CT receipts from companies that are based in other parts of the UK but with significant operations (branches) in Scotland. Estimating the size of the 'branches' CT base in Scotland is complex. The true figure is likely to be within the presented range however the figures are subject to change should a more detailed analysis be conducted. In addition, the presence of a number of large groups with headquarters in Scotland could have a further impact (see paragraph 25).

13. The lower end of the range has been informed by the Scottish Government's own analysis which suggests an average Scottish share of CT receipts of 8.6% between 2004/05 and 2008/09. Provisional findings from work done in the context of Northern Ireland can be applied to the Scottish context to give a rough upper estimate of the total Scottish CT base of around 10.1% of the UK total.

C - Estimating the post-behavioural yield

14. Behavioural effects would arise because of the difference in corporation tax rates between Scotland and the rest of the world, between Scotland and the rest of the UK and because of the difference between tax paid by employed and self employed individuals and companies.

15. The two behavioural effects which are covered by this note are profit shifting and tax motivated incorporation (TMI). Profit shifting arises where companies manipulate transactions so that their taxable profits arise in lower tax jurisdictions, while the activities generating those profits remain in a high tax jurisdiction. TMI occurs because a lower CT rate would increase the tax differential between incorporated and unincorporated businesses, which would lead to more unincorporated businesses, with activity in Scotland, incorporating to reduce their tax bill.

Profit shifting

16. The main rate costing model (approved by the OBR for UK-wide main rate changes) contains a behavioural element to incorporate the sensitivity of the UK tax base to changes in the CT main rate (profit shifting). It is important to consider this when costing changes to the CT main rate because this is a potentially significant behavioural effect arising as a result of changes in the CT main rate. To estimate the impact of profit shifting there are broadly two areas to consider, firstly the mobile tax base and secondly the elasticity to apply to it.

Estimating the mobile tax base

17. There are two elements to the calculation to estimate the proportion of the tax base that is mobile, before applying the elasticity:

- a) Identify profits/receipts from sectors likely to contain firms with mobile profits as a proportion of profits/receipts from all large companies – we estimate this to be 83%.
- b) Identify the proportion of profits within the mobile sectors that are deemed to be truly mobile – estimates are between 35% and 65%, with 50% being deemed central (and is used for these purposes).
- c) Combining the two assumptions gives overall mobile proportions of the tax base of 29%, 42% and 54%. The 42% is used as a central estimate and is consistent with Budget 2011 costings.

Estimating the elasticity

18. There are two main elasticities needed. The first is the 'cross border' elasticity which looks at how companies might shift their 'mobile' profits between the rest of the world and Scotland. Based on a literature review completed in 2007 in HMRC KAI, which suggested the range of plausible elasticities lies between 0.3 and 6.9, a central and constant (cross-border) elasticity of 2 is applied.

19. The second elasticity looks at how companies might move profits from the rest of the UK to Scotland. As part of the costing of a Northern Ireland rate change, use was made of findings in the 2007 Varney report regarding in-country profit shifting, which is an additional consideration for the costs of rate changes within a country. Without any additional research into alternative estimates for this particular elasticity, this methodology uses the elasticity of 4. Whilst 4 was used by the Varney report as a central estimate, the report warns that this is conservative and crucially depends on the assumption that the UK would introduce strict anti-avoidance rules to limit the scope of internal profit shifting. Overall, it seems sensible that the elasticity for in-country profit shifting is greater than cross-border elasticities of profit shifting. However, whilst 4 has been used so far in both the Northern Ireland and Scotland analysis, it could be argued that there is greater scope for profit shifting between English and Scottish companies, so in context of Scotland—beyond the cautions raised by Varney—this means that an elasticity of 4 may tend to under-estimate the true effect.

Profit shifting scenarios

20. By combining the above assumptions and applying them to the CT tax base used here for the main rate, a value for behavioural costing effects can then be fed into the main rate costing model, which then derives the overall behavioural effects on a cash basis. The "Rest of the World (non-UK) to Scotland" line in the table shows the effect of multinational companies transferring some of their mobile profits from outside the UK to Scotland, the

resulting increase in profits arising in Scotland produces an increase in CT receipts. The rest of the UK to Scotland line shows the effect on the UK exchequer from companies shifting profits within the UK to Scotland and consequently being taxed at a lower average rate.

21. Due to the rate cut taking effect immediately in 2011/12, it is also assumed that 75% of the full year behavioural effect is reached in 2011/12 and then 100% of it in 2012/13 and then continuing that behavioural effect at a constant level for the rest of the forecast period.

Tax Motivated Incorporation (TMI)

22. A decrease in the small profits rate for Corporation Tax increases the incentive to incorporate for both employees and the self-employed. This leads to more incorporations as the difference in the tax regimes widen. An increase in the number of tax motivated incorporations will in turn increase corporation tax receipts, however there will also be a negative adjustment made to the Income Tax and National Insurance receipts.

23. The number of new Scottish incorporations as registered with Companies House makes up approximately 5.2% of the total number of incorporations. In 2011-12, it is estimated that following the decrease in the small profits rate, there will be an additional 6,000 TMIs. The number of additional TMIs in the following tax years takes the profile of 100%: 50%: 25%: 12.5% as agreed with the OBR. This reflects the immediate change in behaviour following the announcement of the tax change, which is assumed to decline over time.

24. The estimates of the TMI effects do not take into account any TMIs registering in the rest of the UK and deciding to switch to a Scotland base to take advantage of the lower CT rate. Any such businesses that wanted to register in Scotland to benefit from the rate cut would still have to prove that their activities had legitimately been moved to Scotland. These new companies may be deterred to some extent by the additional administrative burdens placed on them. Overall the TMI cost is likely to be an under-estimate but the extent of this is uncertain.

Other impacts

25. There are certain other potential impacts of a cut in the Scotland CT rate for which estimated costings have been provided. They reflect the differences in the business populations in Scotland and Northern Ireland, for example the presence of a number of large groups with headquarters in Scotland:

- There is a significant presence of life assurance and general insurance companies in Scotland. In the event of a rate cut it is extremely likely that all profits generated by life and general insurance companies domiciled in Scotland would be allocated there and thus taxed at the lower CT rate. After taking into account that a proportion of the profit shifting behavioural cost presented above applies to this sector, the additional estimated cost of this effect is £135 million by the end of the period.

Moreover there would also be a strong behavioural incentive for large English and Welsh-domiciled companies in these sectors (who commonly have a Scottish presence/subsidiaries) to relocate their technical funds to Scotland, increasing the cost to the Exchequer, though we have not yet attempted to quantify this effect.

- A similar issue is that a number of other large banking, other financial and industrial groups are headquartered in Scotland. These groups pay CT through their Scottish parent company. In the event of a rate cut and Scottish ring-fence these companies are likely to find it easier to claim that the CT arises in Scotland. The issue is particularly relevant to other types of financial groups domiciled in Scotland such as banks. The extent of this particular risk would depend on how effective legislative defences against unreasonable profit shifting were in the wake of any CT rate cut. The estimated cost is about £440 million by the end of the period.

Administrative costs

26. The administrative burden on companies would increase, with companies now having to account for profits in Scotland separately to those in the rest of the UK. The resultant increased costs have yet to be calculated but would, necessarily, increase the overall costs of the measure.

D – Second round effects

27. Second round effects on tax receipts (i.e. those flowing from the change in economic activity stemming from the behavioural response to lower tax rates) of this measure are not included in the assessment. Such effects have yet to be considered.