



EMBARGOED UNTIL 00:01 MONDAY 16 APRIL 2007

## **NEW TPA/CEBR DYNAMIC MODEL OF THE UK ECONOMY**

- **CUT IN CORPORATION TAX TO IRISH RATE WOULD DELIVER 60% INVESTMENT BOOST AND 9% GDP, EMPLOYMENT AND DISPOSABLE INCOME BOOST AFTER 15 YEARS**
- **PHASED ANNUAL REDUCTION OF 2p UNTIL 2016 WOULD BE NON-INFLATIONARY AND REDUCE – NOT INCREASE – BORROWING BY ALMOST £30 BILLION**

Reducing Britain's corporation tax rate, currently 30 per cent, to the Irish rate of 12.5 per cent would deliver major economic benefits within 15 years, according to simulations run through a new dynamic model of the UK economy built by the Centre for Economics and Business Research for the TaxPayers' Alliance. The model, which presents a more realistic picture of how the economy responds to tax changes than the "static" analysis produced by HM Treasury, also shows that the corporation tax reduction, phased over nine years, would be non-inflationary and substantially reduce government borrowing.

### **MAJOR ECONOMIC BENEFITS**

The model simulation shows that reducing the main and small company rates of corporation tax to the Irish rate of 12.5 per cent by 2016 would deliver the following economic benefits by 2021 (end of the 15-year simulation period):

- **GDP** would be **8.7 per cent** higher than the base case (the base case assumes no change in taxation);
- **Total fixed investment** would be **60.9 per cent** higher;
- **Total employment** would be **8.7 per cent** higher while **manufacturing employment** would be **10.1 per cent** higher;
- **Disposable income** would be **9 per cent** higher than the base case, largely due to a **13.5 per cent** boost to **wages and salaries**;
- **Consumer spending** would be boosted by **2.3 per cent**;
- The **savings ratio** would be **13.1 per cent** higher than the base case.

## **PHASED CUT WOULD NOT AFFECT INFLATION OR GOVERNMENT SPENDING AND WOULD REDUCE BORROWING**

The model does not simulate an immediate cut in corporation tax to 12.5 per cent. Instead, the adjustment to the Irish rate would be made over nine years, beginning with a 2p cut in April 2008 and further 2p cuts in April of each year until 2016 when there is a cut of 1.5p bringing the rate down to 12.5 per cent in that year. The simulation shows that phasing the corporation tax reduction in this way, as was done in Ireland, would increase economic stability over the next 15 years compared with doing nothing:

- By 2021 **manufacturing productivity** would be **10.6 per cent higher** than the base case, while **unit labour costs** in manufacturing would be **9.9 per cent lower**;
- The **retail price** and **consumer price** indexes would be virtually **unaffected**;
- **Interest rates** would be virtually **unaffected**;
- **Public borrowing** would initially **increase by £3.8 billion**, but by 2021 would be **£28.7 billion lower** than the base case. Corporation tax receipts would not recover, largely because the increased corporate investment spending would benefit from investment allowances, but income tax receipts and indirect tax receipts would be given a major boost due to higher earnings and higher consumption. **Overall tax receipts** would therefore be far **higher** than the base case;
- **Government expenditure** would be virtually **unaffected**.

## **COMPARISON WITH BUDGET 2007 IS CLEAR**

The changes made in Budget 2007 were also run through the new dynamic model. The results show that the 2007 Budget has a relatively small effect on the economy, but that by 2021 the reduction in the corporation tax rate, despite the reduction in capital allowances, results in higher fixed investment (0.6 per cent) and slightly higher GDP (0.3 per cent) than the base case.

Comparing these effects with those of the Irish corporation tax simulation show what a missed opportunity the Budget was. Instead of announcing a single reduction in the main rate of corporation tax, to be financed (on a "static" basis) by reductions in capital allowances, Gordon Brown could have taken the opportunity to announce a gradual adjustment to the Irish rate of corporation tax of 12.5 per cent. Had the Chancellor done that, Britain's economy could look forward to reaping the future benefits.

## **DETAILS OF THE NEW DYNAMIC MODEL**

The TaxPayers' Alliance commissioned the respected Centre for Economics and Business Research to build this dynamic model of the UK economy. CEBR reviewed 120 research papers on the economic and behavioural effects of taxation in order to derive estimates of the impact of tax changes on a number of economic variables. This academic literature review indicated that because of three factors – high skilled people becoming more internationally mobile, greater concentration of earnings in the higher income areas of the economy and increased international mobility of international capital – the UK like all other major economies has become more susceptible to negative impacts from high taxation in recent years. The following elasticities were generated (see the full report for more details):

- An elasticity with respect to the overall tax burden of -0.4 after 5 years for shifting between the shadow economy and the real economy;
- An elasticity of the labour supply with respect to *marginal* disposable incomes of 0.6 on labour supply after 5 years;
- An elasticity of business investment with respect to the corporate tax burden of -0.5
- An elasticity through the competitiveness route that would influence net exports by sufficient to boost GDP by -0.15% after 10 years with respect to a unit change in the tax burden.

## **COMMENT FROM THE TAXPAYERS' ALLIANCE**

### **Corin Taylor, Head of Research at the TaxPayers' Alliance, said:**

*"We commissioned the CEBR to build this dynamic model because it is essential to make and win the argument that reducing taxes is not an optional extra to sensible economic management, but key to it. The results show that substantial, phased business tax reductions are non-inflationary, pay for themselves over time, and deliver large benefits to GDP, employment, investment and family incomes and saving. We hope that the Treasury and opposition parties can build on our work and make dynamic analysis part of their economic thinking. Reductions in taxes do not have to mean equivalent reductions in spending on public services."*

### **Douglas McWilliams, Chief Executive of the Centre for Economics and Business Research, said:**

*"It is important for good economic forecasting and policy-making that thorough dynamic analysis of actual and proposed tax changes is carried out. We would encourage the Treasury to put more of their considerable resources into building their own official dynamic model of the UK economy."*



**Matthew Elliott, Chief Executive of the TaxPayers' Alliance, said:**

*"The Treasury's static modelling has resulted in an institutional bias against lower taxes. We hope that our new reality-based economic model will change the political debate and pave the way for a tax cutting Chancellor."*

**BACKGROUND**

The TPA has led the way in calling for dynamic analysis to be a part of Treasury and opposition party economic thinking. The TPA co-ordinated a letter to the Treasury from 40 leading economists in June 2006 calling for the department to follow the lead of its counterpart in the US and create a "Dynamic Analysis Division".

The TPA's call was then picked-up by the Conservative Party's Tax Reform Commission in October 2006, which proposed the creation of an official dynamic model for the UK economy. Responding to the Tax Reform Commission report the Shadow Chancellor said that once in office he would instruct the Treasury to begin dynamic analysis work but would not immediately incorporate it into official forecasting.

Dynamic analysis is necessary because theory and evidence both show that reducing taxes has a positive effect on the economy and tax revenues, while raising taxes has the opposite effect.<sup>1</sup> It therefore seems absurd not to incorporate it into economic policy-making and forecasting. But the Treasury still relies on "static" analysis in its economic forecasts<sup>2</sup>, and hence has continued to over-estimate the amount of revenue that the Chancellor's tax rises would actually produce. Comparing Budget outturn data with forecasts made in the Budget immediately preceding the relevant financial year shows that, since 2001, the average annual over-estimate of tax receipts has exceeded £6.5 billion.<sup>3</sup> Budget 2007 also admitted that North Sea revenue would be considerably less than forecast, perhaps because the introduction and then doubling of the North Sea Supplementary Charge has not had the desired effect.

The TPA hopes that the Treasury will recognise the reality of the dynamic effects of tax changes and build on the work the TPA has commissioned. Dynamic analysis is an essential part of good economic policy-making.

**ENDS**

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<sup>1</sup> For an excellent summary of the theory and evidence, see Chapter 2 of the Tax Reform Commission's report [www.taxreformcommission.com/report.php](http://www.taxreformcommission.com/report.php)

<sup>2</sup> For example, HM Treasury produces an annual *Tax Ready Reckoner*, which quantifies the revenue effects of changes in tax rates and thresholds. The Ready Reckoner assumes that changing a tax rate by 1p will have an equal and opposite effect either way. Unsurprisingly, this has not proved to be the case.

<sup>3</sup> Outturn tax revenue data taken from Budget two years ahead e.g. for 2005-06 financial year, forecast data published in Budget 2005, which can then be compared with outturn data published in Budget 2007.



## Notes to editors

1. The full report (including a description of the dynamic model and full simulation results of both the Budget 2007 package and the potential impact that might have emerged from using the 2007 Budget to phase down the rate of corporation tax to the Irish rate of 12.5 per cent by 2016) can be found at [www.taxpayersalliance.com/dynamicmodel.pdf](http://www.taxpayersalliance.com/dynamicmodel.pdf)
2. For any enquiries, please contact Corin Taylor, Head of Research, The TaxPayers' Alliance, on 07866 141 110 or [corin.taylor@taxpayersalliance.com](mailto:corin.taylor@taxpayersalliance.com)
3. The TaxPayers' Alliance commissioned the Centre for Economics and Business Research ([www.cebr.com](http://www.cebr.com)) to produce the dynamic model of the UK economy and run the two simulations through it. For further comment on the mechanics of the dynamic model, please contact Douglas McWilliams, Chief Executive, on 07976 647 594 or [dmcwilliams@cebr.com](mailto:dmcwilliams@cebr.com)
4. The dynamic model will be used on an on-going basis to simulate other desirable tax changes as well as taxation plans put forward by the political parties. Economists, journalists and policy experts should contact Corin Taylor (contact details above) if they want to run a tax proposal through the model.