Annex B

HM Treasury's response to the Migration Advisory Committee's consultation on the level of an annual limit on economic migration to the UK

This note provides HM Treasury's response to the Migration Advisory Committee's consultation on the level of an annual limit on economic migration to the UK, through Tiers 1 and 2 of the Points Based System.

Our submission focuses on the following areas:

1. Migration and GDP growth

To examine the impact of possible changes in tier 1 and tier 2 net migration on economic growth, this section considers the following:

(1) estimates of the direct impact on GDP growth through the impact of changes in tier 1 and tier 2 net migration on growth of the 16+ population. For these estimates it is assumed that a change in tier 1 and tier 2 net migration corresponds to a one-to-one change in net migration flows, with subsequent levels of emigration and net migration of other groups held constant and no displacement into other routes to migration. This approach also makes no allowance for specific productivity and employment characteristics of tier 1 and tier 2 migrants;

(2) the direct impact on growth once we try to account for the specific employment rates of tier 1 and tier 2 immigrants;

(3) the direct impact on growth once we try to account for specific productivity levels of tier 1 and tier 2 immigrants;

(4) a discussion of other possible effects of changes to tier 1 and tier 2 immigration, including any impact on return migration and net migration of other groups and; the impact on the capital stock; the possibility of productivity "spillovers" to native workers; and possible displacement effects on the native labour force.

It should be noted that the impact of changes in net migration on growth are subject to very significant uncertainties. The estimates presented here should therefore be interpreted as indicative scenarios which could vary significantly depending on the underlying assumptions and approach used.

Overview of recent trends

Office for National Statistics estimates of long-term net migration flows have fallen back from 212,000 in the year to June 2007 to (provisionally) 176,000 in the year to June 2009 before picking up to 196,000 in the year to December 2009. Applications from

A8/10 nationals to the Workers' Registration Scheme have fallen back sharply with the number of applications in the year to June 2010 just over half the level in the year to June 2008, while National Insurance numbers allocated to non-UK nationals in the year to March 2010 fell by around 17 per cent on the year to March 2009.

Net migration and trend growth

One way to examine the impact of lower Tier 1 and 2 on the economy is to consider its impact on the economy's trend or potential rate of growth.[1] Arithmetically, the economy's trend rate of growth can be decomposed into four components:

- Productivity (output per hour) growth
- Average hours growth
- Employment rate growth
- Population growth (16+ basis)

A. Direct effects

Impact on trend growth through impact on population growth

The most direct way in which changes in net migration will affect trend growth will be through the rate of population growth. All else equal, a change in the rate of population growth will affect the growth rate of the potential labour supply and therefore the trend rate of growth. Other things equal, a given percentage point change in the population growth rate will translate one for one into a change in the trend growth rate.

The growth of the 16+ population can be decomposed into two components: net migration and natural change (i.e. growth of the 16+ population in the absence of net

[1] The economy's trend, or potential rate of growth, is the rate at which the economy can grow on a sustained basis without exerting upward or downward pressure on inflation.

migration).[2] By combining ONS projections of natural change[3] with net migration scenarios it is possible to examine the impact of different net migration profiles on 16+ population growth, and therefore their impact on trend growth through this channel. All else equal, a reduction in 16+ net migration of 50,000 would reduce growth of the 16+ population by approximately 0.1 per cent, although the exact proportionate effect would reduce marginally over time as the size of the population increases.

Table 1 sets out the impact on trend growth of various net migration scenarios through their impact on population growth. In each case the reduction in net migration relates to a reduction in 16+ net migration relative to total tier 1 and tier 2 applicants and dependants in 2009. The scenarios should therefore be interpreted as a reduction in the level of 16+ tier 1 and tier 2 net migration. However, total tier 1 and tier 2 applicants and dependants in 2009 will also include dependants under the age of 16. Therefore the *proportionate* reduction in total tier 1 and tier 2 net migration (relative to 2009) resulting from a given reduction in the level of 16+ tier 1 and tier 2 net migration will vary depending on how many dependants are under the age of 16. The relationship between changes in 16+ net migration and total net migration is also relevant for the impact of changes in net migration on GDP per capita (see below).

For these estimates it is assumed that the reduction in tier 1 and tier 2 net migration corresponds to a one-to-one change with overall net migration flows with subsequent levels of emigration and net migration of other groups held constant; this also assumes that Tier 1 and Tier 2 migrants do not apply through other routes or other routes of the Points Based System, i.e. that there is no displacement into other routes (see page 11 for a further discussion of these assumptions).

[2] Net migration and natural change of the 16+ population are not entirely separable over time as a change in net migration in one year will have some effect the size of the starting population in the following year, which will in turn have a bearing on the level of natural change in that year. Such effects would be relatively small (and would take time to materialise) and would not have a significant bearing on the estimates presented here.

[3] A profile for natural change of the 16+ population can be derived from the annual change in the 16+ population implied by the ONS' 2008-based zero net migration variant population projection.

For the purpose of these scenarios the level of total tier 1 and tier 2 applicants and dependants in 2009 is calculated as the sum of:

- Out of country main applicants (55,275)
- Out of country dependants (42,006)
- In-country extensions (104,370)[4]

Changes out of country main applicants and out of country dependants can be expected to affect total inflows of migrants, whereas changes to in-country extensions may be expected to affect total outflows. As the scenarios below correspond to changes in net flows, both out of country and in country applications have been included in the baseline, although changes to out of country extensions may take longer to achieve. Taken together, this implies total tier 1 and tier 2 applicants and dependants of 201,650 in 2009.

The scenarios illustrate the impact on trend growth of reductions in 16+ net migration of around 50,000, 100,000 and 150,000 by 2015, corresponding to proportionate reductions of 25 per cent, 50 per cent and 75 per cent in total tier 1 and tier 2 applicants relative to the level in 2009 (201,650). For each total reduction two possible trajectories are shown: a gradually phased reduction over 5 years, so that the annual reduction is increased (linearly) each year; and a trajectory where the total reduction is achieved immediately in year 1 and maintained in subsequent years.

As set out in Table 1, the impact of a reduction in net migration on trend growth in any given year can be scaled up or down in a broadly linear way, with annual reductions in 16+ net migration of around 50,000, 100,000 and 150,000 corresponding to annual reductions in trend growth of around 0.1 per cent, 0.2 per cent and 0.3 per cent respectively. As would be expected, the reduction in trend growth in earlier years is less pronounced when the reduction in net migration is phased in gradually compared to the case when it is achieved immediately.

[4] Home Office (2010): *Control of Immigration: Quarterly Statistical Summary, United Kingdom: January-March 2010*, London, Home Office.

Table 1: Net migration scenarios: impact on trend growth through impact on population growth

	2011	2012	2013	2014	2015
Scenario 1: (25% phased reduction)					
Change in net migration (000s)[1]	-10.1	-20.2	-30.2	-40.3	-50.4
Impact on trend growth (pp)	-0.02	-0.04	-0.06	-0.08	-0.10
Scenario 2: (25% reduction by year 1)					
Change in net migration (000s)[1]	-50.4	-50.4	-50.4	-50.4	-50.4
Impact on trend growth (pp)	-0.10	-0.10	-0.10	-0.10	-0.09
Scenario 3: (50% phased reduction)					
Change in net migration (000s)[1]	-20.2	-40.3	-60.5	-80.7	-100.8
Impact on trend growth (pp)	-0.04	-0.08	-0.12	-0.15	-0.19
Scenario 4: (50% reduction by year 1)					
Change in net migration (000s)[1]	-100.8	-100.8	-100.8	-100.8	-100.8
Impact on trend growth (pp)	-0.20	-0.20	-0.19	-0.19	-0.19
Scenario 5: (75% phased reduction)					
Change in net migration (000s)[1]	-30.2	-60.5	-90.7	-121.0	-151.2
Impact on trend growth (pp)	-0.06	-0.12	-0.18	-0.23	-0.29
Scenario 6: (75% reduction by year 1)					
Change in net migration (000s)[1]	-151.2	-151.2	-151.2	-151.2	-151.2
Impact on trend growth (pp)	-0.30	-0.30	-0.29	-0.29	-0.29

[1]16+ basis

GDP per capita

In these estimates, the reduction in net migration brings about an identical proportionate adjustment in employment and output, implying no change in GDP per *worker*. However, there is a small implied effect on GDP per capita growth reflecting the fact that the change in net migration relates to a change in 16+ net migration. In particular, for a 50,000 reduction in net migration GDP per capita growth will fall by

around 0.02 per cent based on the approach outlined above.[5] However, this effect occurs simply as an arithmetic consequence of the fact that the scenarios above consider only the impact of 16+ net migration. If net migration among those under the age of 16 were to move proportionately with 16+net migration then the implied impact on GDP per capita would be zero.

Other trend growth effects

(i) Employment rates

The scenarios presented in Table 1 only consider the impact of changes in net migration on trend growth through its effect on population growth, and do not account for specific labour market characteristics of these migrants, including employment rates and productivity levels. *All else equal*, if migrants were to display lower (higher) employment rates then this would reduce (increase) the impact of a given reduction in migration on trend growth.[6]

Data provided by the ONS indicates that the non-seasonally adjusted 16+ employment rate for those born outside the UK was 59.3 per cent in the three months to June 2010 compared with a non-seasonally adjusted total (i.e. including UK-born and non-UK born) 16+ employment rate of 58.1 per cent (note that these are not the employment rates quoted by the ONS in their monthly labour market statistical bulletin, which are defined on a 16-64 basis). Taking this difference into account would have a negligible effect on the size of the impact on trend growth from different migration scenarios.

However, this considers those born outside the UK as a whole and does not take into account the potential specific characteristics of Tier 1 and Tier 2 migrants. Taking this into account could alter the potential size of the impact on trend growth. According to

[5] Since around 80% of the population are over the age of 16, a 0.1 per cent reduction in the 16+ population would imply a reduction in the total population of 0.08 per cent. As GDP has also fallen by 0.1 per cent, the impact on GDP per person would be 0.1-0.08=0.02 per cent.

[6] In particular, the impact on trend growth from a given reduction in net migration would be equal to the impact on population growth multiplied by the ratio between migrant employment rates and total employment rates

Home Office statistics (see page 5),[7] around 79 per cent of the total number of Tier 1 and Tier 2 applications were applicants for in-country extensions and out of country applicants, with the remainder out of country dependants. If it is assumed that applicants for in-country extensions and out of country applicants would have generally entered employment, and that dependants would have remained outside employment, this implies that around 79 per cent of the total inflow could plausibly be expected to enter employment. In practice a number of dependants will work, while others would be under the age of 16 and hence not part of the working-age (16+) population. Both these effects would tend to push up the implied employment rate of total Tier 1 and Tier 2 applicants, with a greater impact on GDP for a given change in 16+ net migration.

Given a 16+ UK employment rate of around 58 per cent (16+ basis) this would imply (all else equal) a slightly larger impact from a given reduction in Tier 1 and Tier 2 migration than the estimates set out in Table 1. In particular, if it is assumed that the employment rates of those who would have entered are in line with the average rate implied by the 2009 data (i.e. 79 per cent) then the impact on trend growth from a given change in net migration would be around 1/3 higher than the estimates presented in Table 1.

This estimate should be seen as indicative and subject to a number of caveats: the impact on trend growth would differ if the reduction in net migration occurs among groups that would have observed employment rates different from the historical average; similarly the calculation does not take into account the possible employment rates of dependants. Such estimates are therefore subject to significant uncertainty.

GDP per capita

Given that the change in GDP from a given change in net migration would be larger when accounting for the implicit employment rates of Tier 1 and Tier 2 migrants, the

[7] Home Office (2010): *Control of Immigration: Quarterly Statistical Summary, United Kingdom: January-March 2010*, London, Home Office

impact on GDP per head would also be larger. In particular, a reduction in net migration of 50,000 in any given year would be associated with a reduction in GDP per capita growth of around 0.06 per cent when employment rate differentials are accounted for,[8] reflecting the relatively high proportion of tier 1 and tier 2 applicants that are expected to enter work. This estimate is again based on the average characteristics of tier 1 and 2 migrants; in the event that a reduction in tier 1 or tier 2 net migration was among groups that observed significantly different employment rates from the average then this would change the estimated impact on GDP growth and GDP per capita growth.

(ii) Productivity

In addition, the estimates presented in Table 1 do not take account of potential differences in productivity levels of migrants. As Tier 1 and Tier 2 migrants are necessarily skilled or highly-skilled, it might be reasonable to expect productivity levels of Tier 1 and Tier 2 migrants to be relatively high.

While it is difficult to observe productivity levels of Tier 1 and Tier 2 migrants directly, it is possible to make some inference from evidence on earnings. Recent analysis[9] suggests that migrants in Tier 2 observed median earnings of around £35,500 between November 2008 and May 2009. While an equivalent estimate for Tier 1 is not directly available from published sources, analysis published in 2009 suggests that around 50 per cent of Tier 1 applicants observed *previous* earnings in excess of £40,000.[10] Based on data from the 2009 Annual Survey of Hours and Earnings (ASHE) UK-wide median earnings were equal to £21,320 for all employees. If it is assumed that earnings are a reasonable proxy for productivity, then the impact on trend growth from a given

[8] As with the estimates based solely on the population growth effect, part of the impact on GDP per capita growth is an arithmetic consequence of the fact that the scenarios above consider only the impact of 16+ net migration. If net migration among those under the age of 16 were to move proportionately with 16+net migration then the implied reduction in GDP per capita growth would be around 0.04 per cent.

[9] *Analysis of the Points Based System: Tier 2 and dependants*, Migration Advisory Committee, August 2009;

[10] *Analysis of the Points Based System: Tier 1 and dependants*, Migration Advisory Committee, December 2009

reduction in net migration would be somewhat larger than the estimates set out in Table 1 if the likely productivity levels of tier 1 and tier 2 migrants are taken into account. In particular, based on the difference between tier 2 median earnings and UK all employees median earnings, the effects on trend growth from a given change in net migration could be around 2/3 higher than the estimates presented in Table 1.

This estimate is subject to a number of caveats. For example, the implied earnings differential is based on average tier 2 median earnings only and does not account for differences between tier 1 and tier 2 earnings or the possibility that the reduction in migration may be among those that observe significantly different earnings from the tier 2 average. Accordingly such scaling factors should be seen as indicative and part of a range of possible estimates.

GDP per capita

As with the analysis of employment rate differentials, the impact on GDP per head will be larger when taking account of possible differences in the relative productivity of tier 1 and tier 2 migrants. In particular, a reduction in net migration of 50,000 would reduce GDP per capita growth by around 0.09 per cent based on the relative difference between tier 2 median earnings and UK median earnings.[11] Note again that this is based on the average characteristics of tier 2 migrants; in the event that a reduction in tier 1 or tier 2 net migration was among groups that observed significantly different productivity levels from the average then this would change the estimated impact on GDP and GDP per capita growth.

[11] As with the other estimates, part of the impact on GDP per capita growth derives is an arithmetic consequence of the fact that the scenarios above consider only the impact of 16+ net migration. If net migration amongst those under the age of 16 was to move proportionately with 16+net migration then the implied reduction in GDP per capita growth would be around 0.07 per cent.

B. Other effects

The estimates in part A consider only the direct impact of migrants on growth and GDP per capita through the direct effect on population, employment and productivity. It does not consider any dynamic or wider spillover effects from migration. These could include a potential second-round effect on the productivity, employment and earnings of native workers that may have a knock-on effect on the wider economy. These other effects would have a bearing on the extent to which a reduction in net migration affects both trend growth and GDP per capita.

- Population

The estimates in part A assume that a reduction in the number of Tier 1 and Tier 2 migrants feeds one-for-one into lower net migration and therefore lower population. This may not be the case. Lower Tier 1 and Tier 2 inflows could affect immigration of other groups, for instance, limiting the impact on net migration and therefore reducing some of the negative growth effects outlined in part A. It could also affect the flow of people leaving the UK – return migration or emigration. Return migration might be higher – perhaps encouraged by a smaller stock of migrants in the UK – or lower due to increased opportunities for previous high skilled migrants. Emigration of natives may fall back and dampen the impact of lower Tier 1 and 2 immigration on net migration; and therefore population growth and output growth.

- Productivity

The academic literature on immigration and growth suggests that the wider impact on native income growth depends on the skill level of immigrants.[12] For example, as set out in the 2007 cross-departmental report 'The Economic and Fiscal Impact of Immigration'[13] if migrant skills are complementary to natives then the productive

[12] *The impact of immigrants on host country wages, employment and growth*, Friedberg, R M. and Hunt, J., The Journal of Economic Perspectives. Vol. 9, No.2 (Spring, 1995), pp 23-44.
[13] ***The Economic and Fiscal Impact of Immigration, A Cross-Departmental Submission to the House of Lords Select Committee on Economic Affairs***, October 2007.

contribution of all workers could be expected to rise. This spill-over to the productivity of all workers would amplify the growth effects of lower Tier 1 and 2 migration set out in part A.

There may a further effect on productivity depending on how the capital stock adjusts. In the analysis above, the capital stock is implicitly assumed to adjust instantaneously. However, this may not be the case in the short run. If the capital stock is fixed over the short term an increase in the 16+ population may temporarily lower productivity, depending on the extent to which migrants and natives skills are complementary. In the longer run, an increase in high skilled migration would be expected to raise the accumulation of capital, assuming that migrants are complimentary to capital. This long-run impact could amplify the growth effects above.

- Employment and earnings

This focus on growth and productivity may obscure the distributional outcomes. A key concern about immigration is the effect it may have on the labour market in the host country. Immigrants can affect the employment prospects of the resident population (displacement) and the wages paid to residents in employment. For the UK, the body of academic research finds little evidence of these effects. Wadsworth (2010)[14] provides a recent summary of the academic debate and some supporting facts. He concludes "*It is hard to find evidence of much displacement of incumbent workers or lower wages, on average.*" Indeed, there remains some disagreement about the sign of the impact on the average wage of natives. There is, however, some evidence of a negative effect on wages and employment at the bottom end of the skills distribution (see, for instance, Dustman *et al*, 2008[15] and Nickell and Salaheen, 2008[16]).

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[14] *The UK labour market and immigration,* Wadsworth, J., National Institute Economic Review. No. 213, July 2010.

[15] Dustmann, C., Frattini, T. and Preston, I. (2008). *The effect of immigration along the distribution of wages*. CReAM Discussion Paper 03/08. Centre for Research and Analysis of Migration, University College London.

[16] *The Impact of Immigration on Occupational Wages: Evidence from Britain*, Nickell, Stephen, and Jumana Saleheen, Working paper no. 08-6, Federal Reserve Bank of Boston, 2008.

The estimates presented in part A also adopt a static approach to migrant earnings and productivity. They do not consider the future trajectory of migrants' earnings and productivity, which could develop at different rates from natives. For example, some existing evidence[17] points to a dynamic relationship between migrants and native wages over time; however the extent to which this would apply to tier 1 and tier 2 migrants remains unclear.

[17] *Assimilation of Migrants into the British Labour Market*, Dickens, R. and McKnight, A,, LSE, 2008.

2. Public finances effects

The effect of migrants on the public finances will depend on their impact on the UK economy, and on the amount of tax that they pay and the cost of the public services that they consume during their time in the UK. To make a full assessment of the fiscal impact of immigration the effects should be looked at over both a medium and long term time-frame.

Medium term

In the medium term (for example over a 5 year period) lower migration will reduce the trend rate of GDP growth, which, depending upon the degree of spare capacity in the economy, may reduce the actual rate of economic growth and result in the UK economy being smaller than would otherwise be the case.

A lower rate of economic expansion is likely to reduce growth in a number of economic variables, including wages and salaries, consumption and profits, which would have the effect of holding back receipts growth. The effect on public spending will depend on the decisions the Government takes on the funding needs for public services if lower migration results in a lower population than had previously been expected.

Estimates of tax receipts effects

As discussed earlier, 50,000 fewer migrants may approximately reduce potential economic growth by around 0.1 per cent a year. If tax receipts fall in proportion to the lower GDP i.e. the tax to GDP ratio is unchanged, the level of receipts would be around £3.7bn lower after five years.

However, the cyclical adjustment co-efficients that were published alongside the 2008 Pre-Budget report[18] suggest that receipts could respond by more than the change in GDP. Using these estimates suggests 0.1 per cent lower economic growth a year could

[18] Public Finances and the cycle, Treasury Economic Working Paper No.5, November 2008.

reduce receipts by around £5.4bn and the tax to GDP ratio by 0.1 per cent of GDP after 5 years.

These approximate figures should be treated as broad indicative estimates, and in practice the impact on receipts will depend crucially on the composition of growth. For example income tax and NICs provide around 45 per cent of total receipts, which means labour income is particularly important for the receipts take, whereas receipts on corporate income or on investment or exports are not individually as large. The co-efficients are also based on historical relationships between receipts, spending, net borrowing and economic growth, and may not necessarily hold true in the future.

As set out above there is some evidence that the median earnings of Tier 2 migrants are significantly higher than UK-wide earnings (more than £10,000). This would suggest that historical co-efficients used in the above approximation, which are effectively average effects, may underestimate the impact of lower Tier 1 and Tier 2 migration on receipts and the public finances.

Public spending effects

Public spending has two main elements- Departmental spending and Annually Managed Expenditure (AME), which includes large elements of spending that are demand led and closely related to the path of the economy.

AME would normally rise during a cyclical downturn in the economy. For example unemployment would normally rise as the economy moves below potential and benefits spending would therefore rise, and lower tax receipts would increase public sector net borrowing and increase the debt interest costs. However, lower migration implies a structural rather than cyclical reduction in growth, resulting in a smaller population and a smaller workforce but with (all else equal) no cyclical increase in the unemployment rate. If the unemployment rate remained unchanged, a smaller would workforce would generally reduce the *level* of unemployment, which may reduce social security spending.

Obviously a migrant's entitlement to social security benefits will depend on a number of individual circumstances and criteria, and a migrant may also have entitlements to some benefits on returning to their home country, but this will also depend on a number of criteria and individual circumstances. As set out above the evidence also suggests that Tier 1 and 2 migrants have a relatively high employment rate and it may therefore follow that their claims on the benefit system may be smaller than average.

June Budget 2010 set out the spending envelope for Spending Review 2010, which is the overall total for departmental spending to 2014-15. Therefore one assumption could be that in the medium term departmental spending would be in line with the figures set out in the Budget. If it is also assumed that AME spending is broadly unchanged, public spending totals could be assumed to be the same as at the Budget. In this scenario the £'s billion effect on net borrowing would be the same as the effect on receipts. However the percent of GDP effect would be a combination of both spending not falling in response to lower GDP and receipts falling due to lower economic growth.

The below table sets out illustrative effects on borrowing using the cyclical adjustment methodology described above and assuming that public spending is held fixed.

Table 2: Net migration scenarios: impact on trend growth and indicative fiscal impact, assuming public spending is fixed

	2011	2012	2013	2014	2015
Scenario 1:					
Change in net migration (000s)[1]	-10.1	-20.2	-30.2	-40.3	-50.4
Impact on trend growth (pp)	-0.02	-0.04	-0.06	-0.08	-0.10
Fiscal impact (PSNB, £'s bn)	-0.1	-0.5	-1.1	-1.9	-3.1
Scenario 2:					
Change in net migration (000s)[1]	-50.4	-50.4	-50.4	-50.4	-50.4
Impact on trend growth (pp)	-0.10	-0.10	-0.10	-0.10	-0.09
Fiscal impact (PSNB, £'s bn)	-0.7	-1.7	-2.8	-4.0	-5.2
Scenario 3:					
Change in net migration (000s)[1]	-20.2	-40.3	-60.5	-80.7	-100.8
Impact on trend growth (pp)	-0.04	-0.08	-0.12	-0.15	-0.19
Fiscal impact (PSNB, £'s bn)	-0.3	-1.0	-2.2	-3.9	-6.1
Scenario 4:					
Change in net migration (000s)[1]	-100.8	-100.8	-100.8	-100.8	-100.8
Impact on trend growth (pp)	-0.20	-0.20	-0.19	-0.19	-0.19
Fiscal impact (PSNB, £'s bn)	-1.5	-3.4	-5.6	-7.9	-10.5
Scenario 5:					
Change in net migration (000s)[1]	-30.2	-60.5	-90.7	-121.0	-151.2
Impact on trend growth (pp)	-0.06	-0.12	-0.18	-0.23	-0.29
Fiscal impact (PSNB, £'s bn)	-0.4	-1.5	-3.2	-5.8	-9.2
Scenario 6:					
Change in net migration (000s)[1]	-151.2	-151.2	-151.2	-151.2	-151.2
Impact on trend growth (pp)	-0.30	-0.30	-0.29	-0.29	-0.29
Fiscal impact (PSNB, £'s bn)	-2.2	-5.1	-8.4	-11.9	-15.7

The scenarios in Table 2 assume that public spending is held fixed. However, departmental spending on services such as health, education, transport and defence is

funded to serve the needs of the UK population. It follows that a smaller population would imply lower demand for public services.

If the UK population were smaller as a result of lower migration, there could be less demand on some departmental budgets. In terms of the magnitude of potential adjustments, a scale of reference is provided by HM Treasury's long-term public finances model. This model estimates the level of different items of public expenditure based on projected changes in the size and age distribution of the UK population, under different scenarios, including a 'low migration' scenario. The annual level of 16+ net migration assumed for the ONS' 2008-based low migration variant is just over 50,000 lower each year from mid-2009 than the corresponding assumption used for the ONS 2008-based principal population projection.[19] For total public expenditure, under the 'low migration' scenario, total spending is projected to be around £2½ bn lower after five years than under the 'principal' scenario).[20] This reflects a reduction in spending both on items that are age-related but for which there is still a certain amount of expenditure during working age, such as health expenditure; and other items which have no specific link with age but which vary with the overall size of the population, such as spending on transport.[21]

Longer term

The profile of receipts contribution and spending costs over a person's lifetime can broadly be characterised by 3 phases. During childhood, and up until individuals leave full time education, the public spending cost of education and services are not offset by tax paid. Hence, individuals in these age groups represent a net burden to the Exchequer. But throughout their working life individuals tend, on average, to make a net contribution to the public finances, since on average, tax paid outweigh the cost of public services consumed. This position is then reversed in retirement, where the cost of

[19] In particular, the annual level of 16+ net migration assumed for the ONS low migration variant is around 55,000 lower in each year from mid-2009 than the level assumed for the ONS principal population projection.
[20] Assuming 2009-10 as a starting point.
[21] Other spending items, such as expenditure on state pensions, public sector pensions or debt interest, may be expected to be largely invariant to annual changes in the population over the short term.

public services and pensions received by retirees tends to outweigh tax paid in these years.

It follows then that, migrants tend to make a positive contribution to the fiscal position over their lifetimes because they, on average, arrive in adulthood and so the cost of their education does not need to be met by the UK. This sort of analysis is heavily influenced by whether the current budget is in deficit or surplus. For this reason it is best to compare the net fiscal contribution of migrants to that of non-migrants in particular years. The Migration Advisory Committee suggests that the average age of a migrant in the UK is 33; if the fiscal contribution from this age forward is compared to the fiscal contribution of someone over their entire life span we can compare the average net contribution of a migrant with that of the UK native population. In the case of the average male migrant, this is over three times as large as a native UK male.

As migrants age in the UK and move into retirement, they will draw more on public services and pay less in tax than they do during their working lives. Migration will therefore result in net fiscal costs in retirement similar to the net cost arising from the native UK population during those years. But, given that the net fiscal impact of migrants tends to be positive over their lifetime, higher migration helps to support the fiscal costs of an ageing population, even if a proportion of the old-age population itself consists of migrants.[22]

In 2005, the Institute for Public Policy Research (IPPR) produced updated estimates of the net fiscal impact of migration, based largely on previous work by the Home Office. The authors found that migration had a positive influence on the public finances, and also that the impact was growing. Between 1999-2000 and 2003-04 it is estimated that revenue from migrants grew by 22 per cent in real terms as opposed to 6 per cent for the UK-born population. In 1999-2000 the study estimates that migrants accounted for 8.8 per cent of government receipts and 8.4 per cent of government expenditure. By

[22] One caveat to the discussion above is that using representative profiles in this way does not account for any non-linear changes in expenditure related to changes in the size of the population

2003-04 it was estimated that migrants contributed 10 per cent of government receipts and accounted for 9.1 per cent of government expenditure.

3. The potential impact on trade policy

The MAC will also want to consider the potential knock-on impacts of a cap on the negotiation of EU trade agreements, which include components on mode 4 that could conflict with a cap. The potential economic benefits of trade agreements to the UK are large. For example the current EU-Korea Free Trade Agreement (FTA) could produce a £500m annual benefit to the UK, with similar benefits expected from the India and Canada FTA negotiations due to be completed next year, while the completion of the Doha Development Agenda could produce annual benefits of £110bn to the world economy.

Mode 4 commitments are an integral part of our commitments on trade in services. Limiting our ability to take commitments in this area by including Intra Corporate Transfers within a cap could negatively affect our ability to conclude new FTA deals, because we would be withdrawing something which is already an element in many ongoing negotiations and which is wanted by our negotiating partners. This could have the effect of reducing the benefits for the UK in the agreements or potentially causing outline deals to unwind.