# Energising enterprise

## Reforming business taxes in the UK

Sam Dumitriu

bright blue

# Energising enterprise

## Reforming business taxes in the UK

Sam Dumitriu

bright blue

The moral right of the author has been asserted. All rights reserved. Without limiting the rights under copyright reserved above, no part of this publication may be reproduced, stored or introduced into a retrieval system, or transmitted, in any form or by any means (electronic, mechanical, photocopying, recording, or otherwise), without the prior written permission of both the copyright owner and the publisher of this book.

**Bright Blue** is an independent think tank and pressure group for liberal conservatism. Bright Blue takes complete responsibility for the views expressed in this publication, and these do not necessarily reflect the views of the sponsor.

**Director:** Ryan Shorthouse
**Chair:** Sarah Sands
**Members of the board:** Diane Banks, Philip Clarke, Alexandra Jezeph, Richard Mabey

**Design:** Chris Solomons

First published in Great Britain in 2022

by Bright Blue Campaign
ISBN: 978-1-911128-54-0

**www.brightblue.org.uk**

Copyright © Bright Blue Campaign, 2022

# Contents

# About the author

## Sam Dumitriu

Sam Dumitriu is Research Director at The Entrepreneurs Network, a think tank focused on making Britain the best place in the world to start and grow a business. He has published reports on a range of topics including: the share of foreign-born founders among the UK's fastest growing businesses, how the education system can be reformed to promote entrepreneurial abilities, and the importance of management to the UK's productivity puzzle. He is a tax specialist having authored multiple reports on tax reform, including for the Adam Smith Institute and the APPG for Entrepreneurship. His work has been featured in a range of outlets including the FT, Times, Telegraph and BBC.

# Acknowledgements

This report is part of Bright Blue's project on tax reform, which is kindly supported by the Joffe Trust and Social Enterprise UK. The ideas expressed in this publication do not necessarily reflect the views of any sponsors or commissioners of the project.

I would like to thank all those who have contributed views, ideas and challenge throughout. In particular, Wojtek Kopczuk, Giles Wilkes, Pedro Serodio, John Myers, Alan Cole, Daniel Bunn and Ben Southwood.

I am especially grateful to Ryan Shorthouse and Sam Robinson at Bright Blue for their edits and constructive comments during the progress of this report.

All remaining errors and all judgements are the authors' responsibility. The views in this report are those of the author and do not necessarily reflect the views of Bright Blue.

# Tax reform in the 2020s

This report has been commissioned by a high-profile cross-party, cross-sector commission established by Bright Blue to advise on reforms to the tax system in the years ahead to support the post-COVID economic recovery, the restoration of the public finances, and the achievement of better economic, social and environmental outcomes.

Bright Blue's project on tax reform aims to build and articulate a coherent vision, with clear principles and policies, for a tax reforming agenda in the 2020s, focussing in particular on four areas of tax policy: carbon taxation, property taxation, business taxation, and work and wealth taxation.

Bright Blue has commissioned independent experts to provide original analysis and policy recommendations in each of these four areas of tax policy, which the commission will consider before publishing a strategic vision for a tax-reforming, rather than just tax-cutting, agenda over the next decade.

The members of the commission include:

- The Rt Hon David Gauke, Former Secretary of State for Justice
- The Rt Hon Sir Vince Cable, Former Secretary of State for Business
- The Rt Hon Lord Willetts, President of the Advisory Council and Intergenerational Centre at the Resolution Foundation
- The Rt Hon Dame Margaret Hodge MP, Former Chair of the Public Accounts Committee

- The Rt Hon Andrew Mitchell MP, Former Secretary of State for International Development
- James Timpson OBE DL, Chief Executive of the Timpson Group
- Luke Johnson, Entrepreneur and Chairman, Risk Capital Partners
- Emma Jones MBE, Entrepreneur and Founder, Enterprise Nation
- Mike Cherry OBE, National Chairman, Federation of Small Businesses
- Mike Clancy, General Secretary, Prospect trade union
- Victoria Todd, Head of the Low Incomes Tax Reform Group
- Sam Fankhauser, Professor, University of Oxford
- Christina Marriott, Interim Director of Policy and Advocacy, British Red Cross
- Helen Miller, Deputy Director and Head of the Tax Sector, Institute for Fiscal Studies
- Giles Wilkes, Former Special Adviser, Number 10 Downing Street
- Caron Bradshaw, CEO, Charity Finance Group
- Pesh Framjee, Global Head of Social Purpose and Non Profits, Crowe UK
- Robert Palmer, Director, Tax Justice UK
- The Rt Hon Lord Adebowale CBE, Chair, Social Enterprise UK.

The views in this report on reforming business taxes are those of the author and do not necessarily reflect those of Bright Blue or members of our tax commission detailed above.

# Executive summary

The UK's public finances are facing unprecedented pressure. Repaying the cost of measures to support households and businesses through the COVID-19 pandemic and meeting the spending commitments made at the last general election and since will dramatically limit the Government's ability to cut taxes and may necessitate further tax rises depending on the strength of the economic recovery from the pandemic.

In this context, decisions about the tax base will take a greater importance. The structure of business taxes will have major implications across a range of key issues, from productivity and living standards to the future of the high street and the challenge of equitably taxing digital businesses.

There is a major opportunity to reform the structure of business taxation to increase productivity and incentivise investment by shifting the tax burden away from the normal return on investment and risk-taking and towards 'economic rent' (excess returns derived from luck, market power and natural talent).

In reforming business taxes to enable the economy to thrive after COVID-19, this report is guided four key principles:

- **Neutrality.** Markets are our most powerful tool for creating wealth, allocating resources efficiently, and promoting innovation. In the absence of clear market failures, we should avoid distorting market outcomes by favouring certain activities over others. In effect, the tax

system should preserve a level playing field between businesses of different sizes, different sectors, and different investment strategies.

- **Simplicity.** There is an inherent trade-off where the more reliefs and exemptions that are granted, the harder it becomes to administer the tax system. As tax compliance is a fixed cost which large businesses can spread across thousands of sales, complexity disproportionately burdens small and young businesses. Complexity also creates opportunities for avoidance, which undermines trust in the system and generates inequality.
- **Equity.** Taxes are ultimately paid by individuals and when considering the progressivity of any reform we should focus on its economic incidence. All things being equal, a shift in the tax system towards economic rent will be progressive as workers and consumers would benefit relative to shareholders.
- **Revenue.** Any package of reforms should not worsen the UK's long-run fiscal position.

In many questions of policy, there is a trade-off between equity and efficiency, but this is not inevitable. The reform strategy set out in this report would make the UK economy both fairer and more efficient.

The specific policy recommendations proposed are as follows:

## Reforming Corporation Tax

**Recommendation one: Move to the full immediate expensing of capital investment in new plants, machinery, and industrial buildings when the investment super-deduction expires in 2023.** We estimate that this reform will increase investment by 10.85%, GDP by 4.5%, and wages by £3,200. This would be a significant tax reduction on investment, reducing long-run corporate tax revenues by 0.61% of GDP (or £13.5 billion) on a static basis. However, on a dynamic analysis this fiscal cost would be partially offset by higher tax revenues elsewhere resulting from higher output.

**Recommendation two: Eliminate the bias in favour of debt-financed investment by excluding interest from the corporate tax system.** Instead, debt interest payments should no longer be deductible expenses, but interest payments received would not be taxed either. This would increase revenues significantly, offsetting as much as a third (£4.5 billion) of the static cost of moving to a system of full expensing.

**Recommendation three: Allow corporate losses to be carried forward with a factor that adjusts for inflation and a safe rate of return on capital. The 50% annual cap of loss carryforwards should also be eliminated.** The impact and cost of this policy is likely to be small in the short-term as interest rates are low, however if interest rates rise in the future a lack of interest factor for losses could have a significant deterrent effect on risk-taking.

**Recommendation four: The UK should lobby internationally for the OECD's proposed agreement on a 15% global minimum corporate tax to use a cashflow base.** This would ensure tax competition would focus on pro-investment and positive-sum reforms to the tax base, as opposed to zero-sum competition on headline rates. It would also dramatically simplify the taxation of cross-border investments.

## Reforming Business Rates

**Recommendation five: Business Rates should be replaced with a Business Land Tax levied on commercial landowners, based on unimproved land values.** Investments in commercial property improvements would no longer lead to increased tax burdens.

**Recommendation six: To discourage tax motivated shifts from commercial to residential property, a new levy on commercial-to-residential transfers should be introduced.** Commercial landlords converting their property would be forced to make up the difference between Business Rates (or Commercial Land Levy) and Council Tax. Payment would be flexible, allowing landlords to pay the discounted value

of the tax advantage upfront, or alternatively to pay it annually.

**Recommendation seven: Responsibility over Business Rates reliefs and exemptions for Small Businesses, Charities and Agriculture should be devolved to local authorities.** This would mirror local authorities' existing discretionary powers to top-up Charitable Rate Relief from 80% to 100%. Councils may choose to limit the rate of relief available and retain revenues to spend on local priorities, such as funding business incubators or providing assistance to SMEs operating in co-working spaces.

## Reforming business tax reliefs

**Recommendation eight: The Patent Box should be abolished.** This would raise at least an estimated £1.8 billion per year from 2023 onwards.

**Recommendation nine: The Film Tax Relief and High End TV Tax Relief should be abolished.** This would increase tax revenue by an estimated £0.8 billion.

**Recommendation ten: The Employment Allowance should be phased out over the next five years.** This would raise an estimated £2.6 billion. In future, employment support schemes should be targeted more directly at groups with high risk of unemployment, as is the case with the Kickstart scheme.

**Recommendation eleven: Venture capital reliefs such as Enterprise Investment Scheme (EIS), Seed Enterprise Investment Scheme (SEIS) and Venture Capital Trusts (VCTs) should be maintained at current levels and the process for qualifying and accessing these reliefs should be streamlined in line with the Office for Tax Simplification's proposals.** These include administrative changes such as allowing applicants to save partially completed forms online, alongside allowing investors to benefit from the capital gains tax relief in years where they make an income tax loss.

**Recommendation twelve: Social Investment Tax Relief should be preserved, but more resources should be invested in promoting the relief.** There is a sound economic rationale to allow investors in social enterprises to benefit from reliefs similar to the venture capital reliefs. However, to ensure the relief's long-term viability more needs to be done to combat low levels of awareness among accountants and social enterprises, such as targeted information campaigns.

**Recommendation thirteen: The scope of qualifying expenditures for R&D Tax Credit should be expanded to include cloud, data, and User Interface (UI)/User Experience (UX) costs as announced at the 2021 Autumn Budget.** This would correct a major bias against the types of research and development used by digital startups.

**Recommendation fourteen: In order to ensure value for public money, HM Treasury should adopt the German model for scrutinising tax reliefs.** This would legally mandate biannual reviews of corporate tax reliefs based on a standard evaluative framework including: target accuracy; cost-effectiveness; necessity; and sustainability.

# Chapter 1:
# Principles for reform

This chapter explains in detail the four key principles that guide the thinking in this report around reforming business taxes. Specifically, these principles are neutrality, simplicity, equity and revenue.

## Neutrality

The starting point for any tax reform agenda should be a recognition that markets are our most powerful tool for creating wealth, allocating resources efficiently, and promoting innovation. Although markets are liable to fail in cases where externalities are unaccounted for, when there are information asymmetries, or monopoly power is unchecked, they remain our best means of delivering prosperity.

We should be reluctant to use the tax system to distort market outcomes by favouring certain activities over others. While some diversions from the ideal of a neutral tax system can be desirable, such as taxes on pollution or tax credits for research and development, there should be a presumption in favour of neutrality.

Put differently, a commitment to neutrality can be thought of as a commitment to a level playing field. It is a way of ensuring that competition in the marketplace takes place on merit, as opposed to political favouritism.

There are two key reasons for taking this approach. First, while there are some justifications for diverting from neutrality, most diversions are not deliberate attempts to correct a market failure, but the result of

political choices, lobbying from special interests, or simply unintended consequences.

Second, even if there is an easily identifiable market failure, it does not follow that the tax system is the best way of addressing it available to the government. For instance, there used to be a special R&D Tax Relief available only to vaccine manufacturers. But if the aim is to accelerate the pace of vaccine development, then direct funding or advanced market commitments, as used in the COVID-19 pandemic, may be more cost-effective tools.

A completely neutral tax system that does not affect behaviour is not possible in practice, outside of taxes on unimproved land values (insufficient alone to fund a modern state) or per-head taxes levied at a fixed amount on each individual, without reference to income or wealth (seen as fundamentally unfair). All taxes affect behaviour to some extent, but it is possible to move towards a more neutral system.

The inverse elasticity rule is one guiding principle. It states that we should tax goods which are unresponsive to changes in prices at a high rate, and tax goods which are extremely responsive to changes in prices at a low or zero rate. In practice, calculating the demand elasticity of each good or service is not possible. But we can still use the principle when deciding on which broad categories to tax. For instance, there is a strong case for shifting the tax burden onto land, as it is effectively fixed in supply. By contrast, there is a strong case for reducing the burden on marginal investments as they are more responsive to changes in price.

## Simplicity

Another reason to be sceptical of using the tax system to achieve policy goals is the risk of generating excess complexity and the problems associated with it. There is an inherent trade-off where the more reliefs and exemptions that are granted, the harder the tax system is to administer. This is particularly the case when reliefs are generous and tough rules are necessary to prevent abuse. Compliance is a mostly fixed cost for businesses. As a result, while large businesses are able to

spread the cost of compliance over millions of sales, smaller firms face a greater burden as a proportion of their turnover. As a result, there are negative consequences for competition and entrepreneurship.

Complexity can also invite abuse. It creates an incentive for individuals and businesses to redefine activities, or to game the system by identifying loopholes. Sophisticated avoidance strategies that are within the letter, but not the spirit, of the law are typically only available to the well-off. In this sense, complexity can contribute to inequality.

However, there are often trade-offs too between simplification and neutrality. For instance, it may be strictly simpler to tax all capital gains at the same rate as income tax, but without indexation to account for inflation and allowances for capital losses, it is likely to discourage investment and reduce efficiency, as Bright Blue's recent report argued. The VAT registration threshold is another example.[1] It is designed to allow businesses to avoid the complexity of collecting VAT, but it also creates a productivity damaging cliff-edge.[2] Where efficiency and simplification come into direct conflict, in most cases efficiency should be prioritised.

## Equity

It is important to evaluate the tax and spend system as a whole on the issue of progressivity, rather than focusing on the progressivity of individual taxes. Almost all tax systems combine progressive and regressive taxes to fund their state. The most egalitarian systems typically rely on high broad-based taxes on consumption to fund their expansive welfare states. As mentioned, the higher the tax burden, the more important it is to avoid distorting economic activity. In many cases, progressivity is easier to achieve through the welfare system.

When evaluating the progressivity of a tax system, the focus should be on individuals rather than businesses. It is tempting to map

1. Sam Robinson and Ryan Shorthouse, "Rightfully rewarded? Reforming taxes on work and wealth", http://www.brightblue.org.uk/wp-content/uploads/2022/01/Rightfully-Rewarded.pdf (2022).
2. Office for Tax Simplification, "Value added tax: routes to simplification", https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/657213/Value_added_tax_routes_to_simplification_web.pdf (2016).

distributional concerns between low and high earning individuals onto small and large businesses but the comparison is only superficial. In reality, unprofitable or barely profitable businesses do not necessarily contain low-income individuals. For instance, a boutique management consultancy with two employees on £100,000 salaries will benefit from the recently announced Small Profits Rate for Corporation Tax. In this case, the overall progressivity of the tax system will fall. There may still be reasons for treating smaller businesses more favourably but this should be separate to concerns about progressivity.

The issue of equity and neutrality are closely linked. As well as caring about vertical equity – the idea that those with the greatest ability to pay should contribute the most – economists also care about horizontal equity, the idea that we should treat individuals in similar circumstances the same. This should apply to businesses too. Otherwise similar firms should not face a tax penalty for the choice to sell goods in person rather than online (and vice versa for that matter). Neither should firms face a penalty or advantage based on how they choose to finance their investment.

Taking horizontal equity seriously also requires us to consider the tax system over time and not simply look at a given year. For instance, a firm that happens to make all of its profits in one year should not face a higher tax rate than a firm which makes smaller but more consistent profits.

The way we treat firms who are temporarily loss-making is important not just because many innovative technology businesses have built up large tax losses over years, but also because it affects risk-taking behaviour. If we tax the upside from risk-taking, but do not protect against the downside, then there will be a bias against risk-taking. Although we allow businesses to carry forward (and temporarily carry back) their losses, the treatment is not symmetric.

When considering equity both vertical and horizontal, the focus should be on the economic incidence of taxation. Who pays a tax is not always the same person who bears the ultimate burden. For example, employers' NICs are paid by employers, but economic theory predicts

that the ultimate burden will fall upon employees in the form of lower wages.[3] The fact that economic and legal incidence are not necessarily identical is particularly relevant to debates in business taxation. For instance, if the supply of commercial property is relatively fixed then we should expect the incidence of Business Rates to fall mainly upon commercial landlords. As a result, comparing Business Rate payments by an online and offline business may present a misleading picture over whether they are treated equitably.

The true economic incidence of a tax is key to understanding its relative progressivity. In some areas, the question of who ultimately pays is disputed. In the case of Corporation Tax, theory predicts that the incidence will be shared between workers, shareholders, and customers. Estimates vary on the way this breaks down in practice. For instance, some empirical research suggests that 57% of the burden falls upon workers. However, some studies find higher burdens on workers, for example, one finds the burden is as high as 92%, while some economists argue no burden at all.[4] The US Congressional Budget Office assumes about one-fifth of the burden falls on wages, with the rest falling on shareholders.[5]

In the case of Corporation Tax, the choice of tax base has important implications for where the incidence falls and in turn, for its impact across the income distribution. To the extent that it is a tax on marginal investments, as opposed to economic rents, it is likely to pass through into wages. This is because investment affects the size of the capital stock, which in turn affects labour productivity. A revenue neutral shift away from taxing marginal investments towards taxing economic rent would be progressive across the income scale as workers would benefit, while shareholders, who on average have higher incomes, would lose out.

3. J. Symons and D. Robertson, "Employer versus employee taxation: the impact on employment", https://www.oecd.org/employment/emp/4343154.pdf (1990).
4. This is an average of empirical estimates. For more information see the summary of empirical papers in Ben Southwood, "Who pays corporation tax", https://static1.squarespace.com/static/56eddde762cd9413e151ac92/t/56f7200545bf216ba3b89f69/1459036166023/CorpTax8.pdf (2014).
5. Tax Policy Center, "The briefing book: who bears the burden of the corporate income tax?", https://www.taxpolicycenter.org/briefing-book/who-bears-burden-corporate-income-tax (2020).

The issue of incidence and economic rent is also relevant to the question of how to tax multinational businesses. The decision to locate within one country will be determined by the average effective tax rate. While the decision to make a marginal investment in one country once a firm is already located there will be determined by the marginal effective tax rate. The former rate is primarily determined by the headline tax rate, while the latter rate is also determined by the generosity of capital allowances. If tax competition has led to the former to be prioritised over the latter then it will have made the tax less progressive.

## Revenue

The challenging fiscal situation post-pandemic, with a record peacetime deficit (15.1% of GDP) and pandemic-related scarring (estimated to be at 2% of GDP by the OBR), has weakened the government's ability to reduce the overall tax burden.[6]

On Business Rates, the situation is complicated by the Conservative Party's 2019 manifesto pledge to "cut the burden of tax on business by reducing business rates… through a fundamental review of the system."[7] This would appear to imply a commitment to a revenue negative solution for Business Rates. However, in the context of the large and unprecedented Business Rates reliefs provided over the past few years through the course of the COVID-19 pandemic, a revenue neutral proposal may make more sense.

It may be politically tempting to look to businesses rather than individuals to raise revenue, but this would be a mistake. Businesses do not really pay taxes; people do. If taxes on investment in new machinery or workplace training were to increase then it would pass through into lower wages in the long-run. Along the same lines, if our aim is to increase progressivity then taxes on income and property may be more

6. Office for Budget Responsibility (OBR), "Economic and fiscal outlook: October 2021", https://obr.uk/docs/dlm_uploads/Executive_summary_Economic_and_fiscal_outlook_October_2021.pdf (2021).
7. The Conservative Party, "Get Brexit done, unleash Britain's potential: manifesto 2019", https://www.conservatives.com/our-plan/conservative-party-manifesto-2019 (2019).

effective tools than taxes on businesses. However, we may still want to tax businesses as a way of targeting rents deriving from monopoly power or luck. As rents are not a reward to incentivise economic activity, shifting the tax burden towards rents will improve economic efficiency.

# Chapter 2:
# Understanding and reforming Corporation Tax

This chapter outlines the recent history of Corporation Tax within the UK and explains this tax's key shortcomings, before going on to propose reforms to it so it better meets the principles outlined in Chapter One.

## Corporation Tax in context

Chancellor Rishi Sunak's decision to partially reverse the cuts to the headline rate of Corporation Tax (from 28% in 2010 to 19% to 2017, now back to 25% by 2025) over the past decade appears to be a significant break with business tax policy over the last decade. Yet, the reality is more complex. Although headline rates have fallen in recent years, corporate tax receipts as a share of GDP have been remarkably stable since the turn of the millennium hovering around 2% to 2.5% of GDP.[8] Similarly, corporate tax revenues have been roughly stable over the same time period as a share of the total tax take, ranging from 6.5 to 8.5% of GDP.[9]

This relative stability can be explained by the approach of successive Governments to broaden the base and lower the rate. At the same time that the headline rate was cut, so too were allowances

8. IFS, "Corporation tax revenue as a share of GDP over time", https://ifs.org.uk/taxlab/data-item/corporation-tax-revenue-share-gdp-over-time (2021).
9. Ibid.

for investment in plants and machinery.[10] This compounded the UK's already relatively ungenerous tax treatment of business investment. For instance, allowances for investment in buildings and structures were non-existent between 2008 and 2018. By contrast, the OECD average net present value of a deduction for industrial buildings was 47% over the same time period.[11] During this period, the UK was the only OECD country not to have an allowance for this purpose. In 2018, only Chile had less generous capital allowances than the UK. The UK's performance on capital allowances has improved since then, partly as a result of the new investment super-deduction on Corporation Tax described below, but we still rank 30th out of 37 OECD nations.[12]

The Chancellor's announcement of an investment super-deduction in 2021 is by some measures the largest business tax cut ever announced in the UK. For the next two fiscal years, businesses will be able to write-off 130% of their investments in new plants and machinery, in effect receiving a subsidy for investing. In the short-term, this more than fully offsets the negative impact on investment of the scheduled rise to 25%.

This suggests that the Treasury still believes that Corporation Tax has important implications for investment and productivity even if they are no longer persuaded that the headline rate is what matters most. There is now a political consensus on the issue of Corporation Tax that the base is as important as the headline rate.

Over the past decade, a range of studies finding large investment impacts in response to increases in the generosity of capital allowances has influenced a wide range of think tanks across the centre-right to advocate 'full expensing': the ability to write-off capital expenses in full immediately rather than over a number of years. Yet, the super-

10. It is worth noting, this process started when Alastair Darling was Chancellor. In 2008, he cut the headline rate from 30% to 28%, while also cutting the rate at which plants and machinery could be written down from 25% to 20%.
11. Amir El-Sibaie, "Capital cost recovery across the OECD", https://taxfoundation.org/capital-cost-recovery-across-oecd-2018/ (2018).
12. Elke Asen, "Capital cost recovery across the OECD", https://taxfoundation.org/publications/capital-cost-recovery-across-the-oecd/ (2021).

deduction is a temporary measure and it will expire in 2023, when Corporation Tax rises to 25%. At this point, we will have a slightly less competitive headline rate, married with one of the least generous systems of capital cost recovery.

The Oxford Centre for Business Taxation estimated that before the 2021 Budget, the UK's marginal effective corporate tax rate (METR) ranked 24th out of 36 in the OECD.[13] By international standards, the UK's treatment of capital expenditure is ungenerous. Excluding the impact of the temporary super-deduction, the UK ranks 30th out of 37 OECD nations according to the Tax Foundation's Cost of Capital Recovery Index.[14] The average value of a capital allowance (weighted by investment type) is just 61% in the UK. By contrast, the OECD average is 69%.

In 2023, the UK's METR will have increased by 42% (2.9 percentage points). The Oxford Centre for Business Taxation estimates that investment in 2023 will be depressed by as much as 20% relative to its pre-budget figure.[15] The Office for Budget Responsibility also forecast significant falls in investment over the course of the parliament as a result.[16] As business investment in the UK is low by international standards. Further reforms to the tax base to mitigate this fall seem likely.

13. Michael Devereux, "Be cautious about raising the Corporation Tax rate", https://oxfordtax.sbs.ox.ac.uk/article/be-cautious-about-raising-the-corporation-tax-rate (2021).
14. Asen, "Capital cost recovery" (2021).
15. Michael Devereux, "What will the budget do for corporate investment?" https://oxfordtax.sbs.ox.ac.uk/article/what-will-the-budget-do-for-corporate-investment (2021).
16. OBR, "Economic and fiscal outlook: March 2021" https://obr.uk/efo/economic-and-fiscal-outlook-march-2021/ (2021).

**Box 2.1. Corporation Tax: Key facts**

| | |
|---|---|
| Headline rate | • 19% rising to 25% in 2023.<br>• Businesses with annual profits below £50,000 will pay a small profits rate of 19%.<br>• Businesses with profits between £50,000 and £250,000 will pay tax at the main rate reduced by a marginal relief providing a gradual increase in the effective Corporation Tax rate. |
| Capital Allowances | • All qualifying investments in plants and machinery qualify for a 130% investment 'super-deduction'. This will expire in 2023. Prior to the super-deduction, businesses could claim to deduct the full value of any qualifying investment in plants and machinery using the Annual Investment Allowance. This rate has changed multiple times since 2008. It was most recently £1 million a year.<br>• Investment costs relating to plants and machinery can be written down over a number of years at a rate depending on the type of asset. For most plants and machinery this rate is 18% per year. For longer-lived assets, the rate is 6% and for structures and buildings it is 3%. |
| Revenue | • £52.1 billion in 2020-2021. In the years before the pandemic, it raised over £60 billion per annum.<br>• As a share of GDP, Corporation Tax has risen between 2% and 2.9% over the past 20 years. |

## Understanding Corporation Tax

Corporation Tax is best understood as three separate taxes: a tax on marginal investments; a tax on risk; and a tax on economic rent.[17]

### A tax on marginal investments.

Profits are taxed upfront, but not all costs are. Investments in long-lived assets such as new plants and machinery are deducted gradually over time as the asset depreciates. This acts as a deterrent to investment as the value of capital allowances is eroded over time by inflation and the time value of money. If a business invests £100 in a new machine today, the net present value of capital allowances they can claim will be £76. [18,19] If they invested £100 in a new industrial building, the net present value of the capital allowance is just £28.[20] Taxes on marginal investments are considered economically inefficient because they imply differential tax rates on current and future consumption.[21] To the extent that full capital cost recovery is not available, a higher corporation tax reduces the incentive to invest at the margin.

This aspect of Corporation Tax harms labour productivity by reducing the capital-intensity of economic activity in Britain. Over the past 26 years, the UK has seen persistently low levels of private sector fixed capital investment by international standards. In fact, over that time period Britain saw the lowest level of investment in the 36 nation OECD and in all but three years was in the bottom 10th percentile for investment.[22] Over the last 30 years, private-sector fixed capital investment in Germany, France, and the US has been, on average, a third higher than in the UK. We use four times fewer industrial robots per

17. Thank you to Prof Wojceich Kopczuk for clarifying this line of analysis.
18. Adjusting for inflation and the real return on capital businesses require to delay consumption.
19. Assuming they do not claim the temporary super-deduction.
20. The Tax Foundation, "International tax competitiveness index", https://files.taxfoundation.org/20201009154525/2020-International-Tax-Competitiveness-Index.pdf (2020).
21. See Christophe Chamley, "Optimal taxation of capital income in general equilibrium with infinite lives, *Econometrica* (1986), p.607-622 or Kenneth L. Judd, "Redistributive taxation in a simple perfect foresight model", *Journal of Public Economics* (1985), p.59-83.
22. Sam Dumitriu and Pedro Serodio, "Abolishing the factory tax", https://static1.squarespace.com/static/56eddde762cd9413e151ac92/t/5e4c2406d37804306a23664c/1582048264192/Abolishing+the+Factory+Tax+-+Sam+Dumitriu+%26+Dr+Pedro+Serodio+-+Final.pdf (2020).

head than Germany, and nine times fewer per head than South Korea.[23]

It would be unreasonable to fully attribute this to taxes alone, but our relatively harsh tax treatment of investment in new fixed capital will have contributed. Although the UK's headline Corporation Tax rate is the lowest in the G7 and competitive across the OECD, our marginal effective tax rate, the one that determines investment decisions, is lower-mid table, as already mentioned. This disparity can be explained in part by the approach the UK took to lower its headline rate. At the same time that headline rates were cut, the generosity of capital allowances was cut significantly.

For the next two years, the UK will have a zero marginal effective tax rate on most types of new investment due to the super-deduction announced in the March 2021 Budget. However, the marginal effective tax rate will rise significantly in 2023, as explained earlier.

This element of Corporation Tax, the tax on investment, reduces the overall progressivity of the tax. This is because the productivity of workers – and therefore, in the long run, their wages – depends, in part, on the size of the capital stock. In practical terms, workers are more productive when they have access to better equipment, tools, and machines. Compare a garment worker using a sewing machine with one sewing by hand, the former will produce more shirts per hour than the latter. As wages are determined, in large part, productivity underinvestment will lead to lower earnings.

In other words, the effect of Corporation Tax on marginal investments is the mechanism through which workers are most affected. If the tax on marginal investments was eliminated, workers' wages would increase. A Tax Foundation analysis of a revenue neutral shift to full expensing for Corporation Tax in the United States found that it shifts the tax burden onto the top two deciles of earners.[24] The top 1% of earners see the largest increase in tax burden, increasing by 2.6% of their income. By contrast, earners in the 20th to 80th percentile see their tax burden fall

23. International Federation of Robotics (IFR), https://ifr.org/.
24. Kyle Pomerleau, "What is the distributional impact of a destination-based cash-flow tax?", https://taxfoundation.org/what-distributional-impact-destination-based-cash-flow-tax/ (2017).

by 0.6-0.7% as a share of income.[25]

Manufacturing businesses are typically more capital intensive than service businesses, so are more likely to be affected by a tax on marginal investments. This aspect of Corporation Tax also undermines this Government's Levelling Up agenda, as manufacturing as a share of output is almost twice as high in the Midlands and North as it is in London and the South East.[26]

## A tax on risk

Under the status quo, Corporation Tax taxes the upside to risky investments but does not provide full relief for losses. As a result, all things being equal, businesses will prefer safe investments to risky investments. To an extent, this problem is unavoidable without paying out large tax rebates. However, it can be mitigated by policies such as loss carryforwards, where tax losses from previous years can be offset against future tax bills, and loss carrybacks, where tax losses from the current year can be offset against past tax bills. The former is a well-established feature of our tax system, while the latter has been used to support businesses during the pandemic and in other past recessions.

Even with the aforementioned policies, Corporation Tax still functions as a tax on risk because loss carryforwards are not adjusted for inflation or the time value of money. As a result, due to current inflation alone, a £100 loss made in 2010 that took 10 years to carry forward would lose £24 worth of value. To the extent that loss carryforwards are not adjusted for inflation and the time value of money, a higher Corporation Tax reduces the incentive to make a risky investment at the margin.

The UK's treatment of tax losses has worsened in recent years. In 2016, a 50% cap was placed on the share of corporate profits that could be offset using loss carry forwards.[27] This increased short-term revenues,

25. The bottom 20th percentile see a 0.4% fall in tax burden as a share of income.
26. Neil O'Brien, "Firing on all cylinders: building a strong economy from the bottom up", https://www.ukonward.com/wp-content/uploads/2019/05/ONWJ7142-Firing-on-all-cylinders-report-190530-WEB-1.pdf (2019).
27. In the case of banks, this cap is 25%.

but has reduced them over the long-term, causing the IFS to criticise the move as having "no good economic rationale."[28]

### A tax on rents

Even if the two previous problems were eliminated by allowing full capital cost recovery and full symmetric treatment of losses, Corporation Tax would still be a substantial revenue raiser. Some investments are not merely break-even; they would take place whether Corporation Tax increased by 1% or 10%. The excess profits from such investments are known as economic rent. They are the result of luck, market power, access to firm specific capital, natural talent, or regulatory capture. Taxes on rent are considered efficient because they do not affect behaviour at the intensive margin. Apple, for example, would still produce the next iPhone even if they were unable to fully offset capital expenditures or claim relief on losses.

The third element of Corporation Tax helps explain why we tax businesses on their profits directly, instead of taxing individuals. Corporation Tax allows us to tax rents resulting from economic activity accruing to foreign shareholders and other hard to tax entities.

There is a strong efficiency based case for a tax on rents in the corporate sector. The aim of Corporation Tax reform should be to minimise, or eliminate tax on marginal investments and risk, and, if possible, shift the tax to economic rents.

## International tax competition and avoidance

The analysis above focused on how Corporation Tax affected the behaviour of businesses at the intensive margin. In other words, it looked at how taxes affect the decision-making of businesses in the UK. However, this is not the only margin from which Corporation Tax can affect behaviour. We must also consider the extensive margin,

28. Helen Miller, "What's been happening to corporation tax?", https://ifs.org.uk/uploads/publications/bns/BN206.pdf (2017).

whether or not a business chooses to locate in the UK or elsewhere. This element of taxation is determined by the effective average tax rate (EATR) on corporate profits. In other words, international businesses look at the tax burden across all of their investments, including investments that generate super-normal profits, rather than simply focusing on marginal investments. As a result, the headline rate of Corporation Tax is still an important determinant of investment levels, even in cases where businesses are able to fully offset capital expenditure and treatment of losses is symmetrical.

This problem must be addressed if we are to convert Corporation Tax into a targeted tax on economic rent in the corporate sector. If firms are able to shift activity and investment to lower tax jurisdictions easily, then a significant proportion of the burden of Corporation Tax will fall upon workers, not shareholders, who experience lower wages in response to a diminished capital stock. Estimates of this impact vary, but the consensus in the academic literature suggests that Foreign Direct Investment (FDI) declines by 2.5% for each 1 percentage point rise in the EATR.[29] If, as Professor Michael Devereux – Director of the Oxford University Centre for Business Taxation – estimates, the UK's EATR rises by 2.3% (relative to 2020) in 2023 then FDI will fall by 5.75%.[30]

One major concern in recent years has been the practice of profit shifting, where multinational corporations (MNCs) are able to avoid taxes by allocating revenue and expenses across jurisdictions in order to minimise their tax payments. This is often referred to as Base Erosion and Profit Shifting (BEPS), as discussed in detail in Box 2.2 below. For instance, corporations with subsidiaries across different countries often trade with each other. Businesses have a relatively high degree of flexibility to set the prices in intracompany trades. This creates an opportunity for avoidance. A subsidiary in a low tax jurisdiction has

29. Devereux, "Be cautious about raising the corporation tax rate".
30. Deveruex, "What will the budget do for corporate investment?".

an incentive to inflate its profits relative to subsidiaries in high tax jurisdictions. As a result, a company could avoid tax by setting the price of a good being sold from a low tax to high tax jurisdiction artificially high. Transfer pricing, the practice described here, is one of many methods at the disposal of MNCs.[31]

This problem is likely to be most acute in sectors such as tech, where IP and intangible investments are a particularly important part of the production process. This has been a particular focus of international efforts and the UK has implemented a targeted Digital Services Tax on tech giants such as Google, Amazon and Facebook. This tax, which came into action in 2020, applies to digital businesses with more than £500 million revenue worldwide and at least £25 million revenue derived from UK users. If the business's revenues exceed these thresholds, its revenues from social media, search, or online marketplaces derived from UK users are taxed at a rate of 2%.

**Box 2.2. Base Erosion and Profit Shifting (BEPS)**

Base erosion and profit shifting (BEPS) refers to practices where multinational businesses exploit mismatches or gaps in different tax jurisdictions to shift their profits to low/no-tax jurisdictions. In most cases, these practices are legal. In particular, the practices are associated with IP-focused businesses, such as tech businesses, where activity is difficult to assign to the correct jurisdiction. However, there are also debt-based profit shifting, such as where a company in a high-tax jurisdiction borrows from a company in the same group in a low-tax jurisdiction at an artificially high tax rate to inflate their profits in that jurisdiction.

31. For a summary of all the methods available, see: James R. Hines Jr., "How serious a problem is base erosion and profit shifting?", *Canadian Tax Journal* (2014), p.443-453.

Addressing BEPS requires international co-operation and most international efforts have been focused at the OECD and G20 level. Following extensive negotiations, a two-pillar approach covering 141 countries and jurisdiction contributing more than 90% of global GDP was agreed. The first pillar applies to around 100 multinational businesses (groups with greater than €20 billion in worldwide revenues and 10%) and re-allocates part of their profit (25% of profits if their profits exceed 10% of revenue) to the countries where they sell their products and provide their services, where their consumers are. The second pillar applies to any multinational with more than €750m annual revenue and applies a 15% minimum tax rate if their effective tax rate in any jurisdiction is below 15%. This is designed to reduce the incentive to engage in any base erosion or profit shifting activity. The measures will replace existing unilateral measures such as the Digital Services Tax, which can lead to double taxation and trade disputes. This is set to be effective in 2030.[32]

A key motivation for targeting profit shifting is that it undermines the principle of a level-playing field between multinationals and domestic SMEs. Pillar 1 of the OECD's Base Erosion and Profit Shifting initiative (BEPS) looks at reallocating taxing rights across nations to deal with the difficulty in assigning profits for digital businesses.

Unsurprisingly, high headline corporate tax rates create a greater incentive to engage in profit shifting. As a result, international efforts such as the OECD's BEPS initiative have also included measures which aim to reduce tax differentials between nations, the so-called global minimum tax (Pillar 2).

Although profit shifting is a major concern for policymakers, quantifying the problem is difficult and there is no academic consensus over its impacts on revenues. Estimates from the OECD and IMF

32. OECD and G20, "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy", https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.htm (2021).

suggest that it reduces by global revenue $100 to $240 billion, which translates to between 4% to 10% of global corporate tax revenue, with its effects most pronounced in non-OECD nations. An estimate from economist Kimberly Clausing is slightly higher ($280 billion) but in the same ballpark. However, this figure fell to $100 billion in response to methodological criticisms from academic accountants.[33]

The high level of political concern to address profit shifting may be disproportionate. Economist James Hines notes that the problem is relatively small when considered as a share of total tax revenue. Referencing low estimates of elasticity of income reported, he notes: "Even if one were to double, or quintuple, this figure, it would amount to less than 1 percent of [OECD] tax revenue."[34] A key challenge in assessing the scale of profit shifting and the potential benefits of reforms is that most studies were conducted before the most recent measures such as the 2015 Diverted Profits Tax and the 2017 US Global Intangible Low Tax Income rules have come in and certain controversial tax measures such as the 'double Irish' arrangements have expired.[35]

Anti-avoidance measures are not costless either. De Mooij and Li Liu find that transfer pricing regulations can have negative impacts on FDI, similar to increasing the headline corporate tax rate.[36] Other studies find similar trade-offs.[37] Regimes designed to prevent profit shifting also create a high compliance burden for multinationals regardless of whether they engage in profit shifting or not.

33. Elke Asen, "What we know: reviewing the academic literature on profit shifting", https://files.taxfoundation.org/20210621154315/What-We-Know-Reviewing-the-Academic-Literature-on-Profit-Shifting-TN-Int.pdf (2021).
34. Hines, "How serious a problem is base erosion".
35. The Double Irish was a tool used by US multinationals to avoid taxes on profits generated outside the United States.
36. Ruud A. de Mooij and Li Liu, "At a cost: the real effects of transfer pricing regulations", https://www.imf.org/en/Publications/WP/Issues/2018/03/23/At-A-Cost-the-Real-Effects-of-Transfer-Pricing-Regulations-45734 (2018).
37. Peter Egger and Georg Wamser, "The impact of controlled foreign company legislation on real investments abroad. A multi-dimensional regression discontinuity design", *Journal of Public Economics* (2015), p.77-91.

## Recommendations for reforming Corporation Tax

**Recommendation one: Move to the full immediate expensing of capital investment in new plants, machinery, and industrial buildings when the investment super-deduction expires in 2023.** To increase investment and productivity, the Government should allow businesses after 2023 to deduct the full cost of capital expenditures from their annual taxable income. This would, in effect, treat investment in new plants and machinery as they would any other business expense.

Unlike the Chancellor's current investment super-deduction, this would be a permanent measure designed to reduce the negative impact of the planned Corporation Tax rise to 25% in 2023. While the temporary super-deduction is an effective tool to stimulate investment and aggregate demand during an unprecedented economic slump, it would not be an effective long-term policy as it would have the unintended consequence of subsidising loss-making investments. It is also worth noting that the super-deduction's impact on investment is complicated by two countervailing forces. While it creates an incentive to bring investment forwards, and counters an incentive to delay investment in response to the rate rise, its impact will be muted by future uncertainty.

Moving to full expensing permanently after 2023 for all capital investment as part of a shift towards business cashflow taxation, as explained in Box 2.3 later, would reduce the marginal effective tax rate for investment to zero. It would in effect eliminate the bias against investment, at the intensive margin, entirely.

A range of empirical studies from the UK and US find large investment boosts in response to expansions of capital allowances. In the UK, Devereux, Xing, and Maffini found that businesses which qualified for 'First Year Allowances', which allow businesses to deduct 40% of an investment's costs in their first year, increased their investment levels by 11% relative to similar businesses that were not eligible. In the US, Ohrn et al found that states which implemented full expensing style

policies saw investment increase by 17.5% and wages by 2.5%. These findings produce estimates of the elasticity of investment in response to the user cost of capital in line with past studies.[38] On average they predict that a 1% fall in the post-tax cost of investment leads to an 8.6% increase in investment.

Using these estimates, we predict that moving to a system of full expensing for investment in plants, machinery and industrial buildings will increase investment by 10.85%; GDP by 4.5%; and wages by £3,200.[39] This would be a significant tax reduction on investment, reducing long-run corporate tax revenues by 0.61% of GDP (or £13.5 billion) on a static basis. The fiscal cost would be highest in the short-term, but fall substantially over time. Additionally, the fiscal cost would be offset by higher tax revenues elsewhere resulting from higher output.

This measure would reduce the tax burden on labour by increasing the size of the capital stock and it would benefit the regions where manufacturing represents a larger share of GDP, such as the North-East, the most.

**Recommendation two: Eliminate the bias in favour of debt-financed investment by excluding interest from the corporate tax system.**

Moving to a system of full expensing without limiting the deductibility of interest expenses would have the unintended consequence of subsidising debt-financed investments. This would particularly be the case for investments in assets with very long lives, such as industrial buildings. The cause of the debt-over-equity bias within our tax system is that payments to holders of debt can be deducted, but the real return necessary to compensate shareholders for providing equity is not. Full expensing eliminates the latter issue, by reducing the effective marginal tax rate for equity financed investment to zero, but preserves the former.

38. J. A. Kay and M. A. King, *The British Tax System* (Oxford: Oxford University Press, 1990).
39. Deloitte, "Oil and gas taxation in the UK", https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Energy-and-Resources/dttl-er-UK-oilandgas-guide.pdf.

This is a problem for two key reasons. First, it creates a bias in the type of investment that is funded. Equity investments are more appropriate for high-growth technology companies for example. Second, it contributes to financial instability. Many economists believe high levels of debt make financial crises more likely.[40]

One way to reduce the tax bias in favour of debt would be to effectively exclude interest from the tax system altogether. In other words, debt interest payments would no longer be deductible expenses, but interest payments received would not be taxed either. This approach would bring the marginal effective tax rate on debt financed investments in line with the marginal effective tax rate on equity financed investments. It would have the added benefit of reducing the administrative burden of taxes as businesses would no longer have to keep track of interest payments. As some forms of profit shifting utilise interest payments between subsidiaries, this measure would reduce the need for special anti-avoidance measures such as the UK's worldwide debt cap.

Empirical studies looking at reforms designed to eliminate the tax bias in favour of debt show significant reductions in leverage and improvements in financial stability.[41,42]

Eliminating the debt bias would partially offset the costs of moving to a system of full expensing. In 2016 the Tax Foundation estimated that such a move would increase revenues significantly, offsetting as much as a third of the cost of moving to a system of full expensing.

**Recommendation three: Allow corporate losses to be carried forward with a factor that adjusts for inflation and a safe rate of return on capital. The 50% annual cap of loss carryforwards should also be eliminated.**

The way losses are currently treated in the Corporation Tax system

40. See Dumitriu and Serodio, "Abolishing the factory tax".
41. This is relative to the implied cost of capital in 2023 onwards when the super-deduction expires and the headline rate increases to 25%. Author's own calculations.
42. See Anat Admati and Martin Hellwig, *The bankers' new clothes: what's wrong with banking and what to do about it* (Princeton: Princeton University Press, 2013).

creates a bias towards lower risk investments and distorts firm behaviour. There is no economic rationale for the tax system to prefer a businesses to realising losses and profits at any specific time, yet the status quo favour businesses who produce steady-and-stable profits over businesses with more volatile profitability.

A key problem is that although losses can be carried forward and offset against future tax returns, inflation and the time value of money erode the value of the tax losses. To preserve the present discounted value of losses, firms should be able to carry forward losses with a factor that adjusts for inflation and a safe rate of return on capital. The 50% annual cap of loss carryforwards should be eliminated.

Additionally, this policy should be applied in reverse to loss carrybacks after the temporary extended loss carry back for businesses expires. This would prevent loss carrybacks from inadvertently favouring established firms over new entrants.

The impact and cost of this policy is likely to be small in the short-term as interest rates are low, however if interest rates rise in the future a lack of interest factor for losses could have a significant deterrent effect on risk-taking.

**Box 2.3. The Business Cashflow Tax**

The first three recommendations set out in this chapter would convert Corporation Tax (CT) into a Business Cashflow Tax (BCT).

The key difference between CT, as it currently exists, and a BCT, is that a BCT makes no distinction between spending on inputs that are consumed immediately (such as wages) and spending on capital (such as plants and machinery).

The tax base is simply money received for selling goods and services minus money spent on producing/acquiring goods and services.

Under a BCT, there is no need to define true economic depreciation or for businesses to keep track of depreciation schedules. Instead, the full value of spending on capital goods is expensed immediately.

A BCT is analogous to the government taking an equity stake in every business. Suppose a business were to spend £1million on a new capital project. A hypothetical 50% BCT would see their taxable income reduced by £1 million and their existing tax bill would fall by £0.5 million. Of the future profits from the project, half would go to the Exchequer. In this example, the Government is in effect a 50:50 investor in the project. Importantly, any project which is profitable would go ahead. This is not the case with CT as it is currently designed as inadequate deductibility for capital expenditure can cause projects that would be profitable in the absence of the tax to become unviable.[43]

We use a form of BCT, the Ring Fence Corporation Tax, to tax the profits from North Sea Oil. They are commonly used around the world to tax natural resources as they only tax the rents, or excess profits, firms can access without discouraging full exploitation of the resource.[44]

Moving to a BCT would also require a change to the way we treat interest payments. Under the status quo, they are tax deductible, which creates a bias in favour of debt finance and would effectively subsidise some debt-financed investments. There are two broad approaches that could be taken to resolve this:

1. Disallow the deductibility of interest payments.
2. Allow the deductibility of interest payments, but treat new borrowing as a taxable receipt.

This would be a dramatic simplification of the tax system. Investments in long-lived assets would be treated the same as day-to-spending and businesses would no longer have to keep track of depreciation schedules. This reform would also eliminate the current bias towards debt-financed investment by eliminating deductibility of business interest paid, while also eliminating tax on interest received.

By reducing the tax burden on investment and shifting it to economic rent, this reform would increase both the progressivity and efficiency of the way we tax corporate profits.

43. Glenn Schepens, "Does the tax advantage of debt impact financial stability?", https://www.ecb.europa.eu/pub/economic-research/resbull/2016/html/rb160927.en.html (2016).
44. Ruud A. de Mooij and Shafik Hebous, "Curbing corporate debt bias: do limitations to interest deductibility work?", https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2921052 (2017).

**Recommendation four: The UK should lobby internationally for the OECD's proposed agreement on a 15% global minimum corporate tax to use a cashflow base.**

At the G7 summit in 2021, agreement was reached on a 15% global minimum corporate tax rate for large multinationals. It represented substantial progress on a seemingly intractable issue, but as Glenn Hubbard, the former Chair of the Council of Economic Advisers, points out: "A 15% rate is not particularly useful without an agreement on what the tax base is."[45]

In particular, the US is likely to be concerned that competitors will use special tax breaks to lure away successful industries, such as technology. Similarly, Chancellor Rishi Sunak is reported to have made a forceful case for an exception for financial services.[46] Hubbard warns that efforts by the Biden Administration to reduce deductions for investments in overseas plants and machinery could reduce cross-border investment flows.[47]

A better approach would be for the UK to lobby at an international level for the proposed global minimum tax to have a cashflow base rather than use the existing proposal, which excludes an amount of income that is 5% of the carrying value of tangible assets and payroll. In other words, to allow countries to introduce full expensing for investments. This would have two positive impacts. First, it would shift the burden of corporation tax away from marginal investments and on to economic rents. As mentioned, this shift would be progressive as higher investment levels globally will improve productivity. Importantly, tax competition would focus on pro-investment and positive-sum reforms to the tax base, as opposed to zero-sum competition on headline rates. This aspect would better align the global minimum corporate tax with the goal of raising more revenue from highly profitable large multinationals.

Second, it would contribute to a global simplification of cross-

45. Glenn Hubbard, "Governments should tax cash flow, not global corporate income", *Financial Times*, 9 June, 2021.
46. Emma Agyemang, George Parker, Chris Giles, "UK presses for City of London carve-out from G7 global tax plan", *Financial Times*, 8 June, 2021.
47. Hubbard, "Governments should tax cash flow, not global corporate income".

border investment as businesses would no longer need to keep track of different investment schedules in different countries. It would also reduce the need for complex anti-avoidance measures and sticking plaster measures such as the Digital Services Tax.

# Chapter 3:
# Understanding and reforming Business Rates

This chapter outlines recent developments and debate around Business Rates, including during the pandemic. It goes on to identify three key issues with the current Business Rates regime and suggests reforms to mitigate them.

## Business Rates in context

At the 2019 Election, the Conservatives pledged to "cut the burden of tax on business by reducing business rates... through a fundamental review of the system."[48] There is broad agreement that the status quo is far from ideal, yet many proposed alternatives, such as online sales taxes, appear to raise more problems than they solve.

This review was prompted by significant criticism from a range of business groups, including the Confederation of British Industry, Federation of Small Businesses, and British Chamber of Commerce. The tax, which is levied on non-domestic properties, brings in £25 billion each year.[49] At the last Budget, the Chancellor decided against fundamental reform of the rates system when he concluded the Treasury's inquiry into the tax, opting instead to announce new reliefs, move to more regular revaluations, and announce a consultation into

48. The Conservative Party, "Manifesto 2019".
49. Office for National Statistics, "National non-domestic rates collected by councils in England: 2020 to 2021", https://www.gov.uk/government/statistics/national-non-domestic-rates-collected-by-councils-in-england-2020-to-2021/national-non-domestic-rates-collected-by-councils-in-england-2020-to-2021 (2022).

the creation of a new online sales tax designed to reduce the overall rates burden.

Targeted Business Rates reliefs have been used throughout the pandemic to assist businesses in difficulty. In total, £16 billion worth of relief was granted in 2020/2021.[50] At the most recent Budget, the Chancellor announced a further £7 billion in relief. This included a temporary 50% relief for retail and hospitality businesses capped at £110,000 per business, and a freeze in the multiplier (scheduled to rise with inflation) until 2023. Revaluations will now happen every three, not five years, to better reflect rental market conditions. Past revaluations have been delayed with the last revaluation happening in 2015. A new relief will ensure that businesses who make improvements to a businesses energy efficiency will not see their bill rise the following year. This is all summarised in Box 3.1 below.

**Box 3.1. Business Rates: Key facts**

Business Rates are charged on any properties used for non-domestic purposes such as shops, offices and factories.

Business Rates are calculated based on a property's open market rental value, as assessed by the Valuation Office Agency. Annual Business Rates are calculated by applying a multiplier. The multiplier is currently 51.2p or 49.9p for rateable values below £18,000 (below £25,000 in Greater London).

In 2019-2020, Business Rates raised £25 billion, falling to £14 billion during the pandemic due to targeted business support coming in the form of business rates relief.[51]

50. Ibid.
51. Ibid.

**Main Business Rates Reliefs and Exemptions**

| | |
|---|---|
| Small Business Rate Relief | Businesses with only one property do not have to pay Business Rates, if the property has a rateable value of £12,000 or less.<br>The relief is gradually tapered away for properties with rateable values between £12,000 and £15,000.<br>If a business uses multiple properties, they can still claim the relief on their main property, if the combined value of all of their properties is less than £20,000 and no other property has value of £2,899 or more. |
| Small Business Multiplier | Properties with rateable values between £15,000 and £51,000 pay a slightly lower rate of Business Rates, 49.9p instead of 51.2p. |
| Charitable Rate Relief | Charities and community amateur sports clubs can apply for charitable rate relief of up to 80% if a property is used for charitable purposes.<br>Councils can choose to top this up to 100%. |
| Empty Buildings Relief | Landlords do not have to pay Business Rates on empty buildings for three months (six months for industrial buildings).<br>For some types of buildings (such as Listed Buildings), the relief lasts until reoccupancy. |
| Exemptions | Agricultural land and buildings, including fish farms, are exempted from Business Rates.<br>Buildings used for public religious worship are also exempt. |

## Understanding Business Rates

As established in Chapter Two, a useful way to understand the way a tax affects behaviour is by analysing it as multiple separate taxes. In the case of Business Rates, we can break the tax apart into two taxes: a tax on unimproved land; and, a tax on improvements to commercial buildings.[52]

The former tax, as noted in a recent Bright Blue report, is favoured by economists.[53] This is because the supply of unimproved land is essentially fixed.[54] Unlike the supply of cars, or almost any consumer good, landowners have no incentive to reduce the supply of land in response to any tax. The rents landowners receive owing solely to the unimproved value of land are not economic rewards for engaging in productive behaviour. For instance, a landowner a short distance from the soon-to-be-built 'Old Oak Common' superhub station might suddenly see their land values rise, but it is not a result of any effort on their part. There are some historical exceptions. For instance, railways such as the Metropolitan line were built on the basis of land speculation. However, this model is hard to execute due to the way the planning system works.[55]

In terms of the second aspect of Business Rates, the tax on improvements to commercial land, we can again split this into two taxes: a tax on historic improvements on commercial property; and, a tax on future investment in commercial property, including maintenance.

Provided that taxes on historic improvements are not set so high that landowners have an incentive to demolish their property or to convert it into alternative use, this part of the tax is efficient. It should have little impact on economic activity. Admittedly, the tax on land and tax on historic improvements, while economically efficient, may raise questions of fairness, if rates increase excessively. Commercial landlords,

52. Improvements refers to anything built on top of the land.
53. Paul Cheshire and Christian Hilber, "Home truths: options for reforming residential property taxes in England", https://www.brightblue.org.uk/portfolio/home-truths-options-for-reforming/ (2021).
54. It may be possible in extreme cases to reclaim land from the sea, but the process is extremely costly.
55. One exception may be theme parks. Where land closeby may benefit from positive spillovers, such as the prospect of being acquired for an additional park area. Another example might be property developers investing in communal assets, such as gardens, in order to increase the value of nearby properties in the same development. This however is more relevant to the taxation of residential rather than commercial property.

many of whom are pension funds, may feel as if the rules of the game have changed without warning and might reasonably argue that they would not have made the same purchase if they foresaw the tax rises in advance.

The tax on future investment in commercial property should be our primary concern. It creates a disincentive for commercial landlords to invest in improving the stock of commercial property, in effect, reducing the supply of commercial property.[56] The reduction in supply will translate to higher occupancy costs for businesses. At the margin, this will lead to some economic activity, which would otherwise take place, stopping as it is no longer profitable. It will also mean that property-intensive businesses, for instance restaurants, will face a competitive disadvantage against property-light business, for example the 'dark kitchens' that have proliferated on food delivery applications.

Many figures, such as Tesco's CEO Ken Murphy, have argued that the current Business Rates system discriminates in favour of online marketplaces to the detriment of traditional high street retailers. Typically, they use relative Business Rates bills as evidence. For instance, Amazon sold £19.3 billion worth of goods in 2020 and paid just £71.5 million. By contrast, Arcadia Group, which owned Topshop, Burton and Dorothy Perkins at the time, would have paid £91 million in Business Rates on £4.5 billion of sales.[57] At face value, this is persuasive evidence. However, in order to understand whether or not the status quo has created an unlevel playing field, we need to know the economic as well as the legal incidence of Business Rates. If commercial landlords bear the ultimate cost of paying Business Rates, then businesses like Amazon receive no advantage over bricks-and-mortar retailers through paying lower Business Rates bills.

Who bears the burden of Business Rates depends on the extent to which the supply of commercial property is fixed. As established above, Business

56. For example, a commercial property owner may find that adding an extra floor to their office space is no longer profitable due to the prospect of higher tax bills.
57. BBC, "Tesco tells chancellor to hit online rivals with sales tax", *BBC News*, 8 February, 2021.

Rates are a tax on unimproved land values, which are fixed in supply; a tax on existing commercial property (relatively fixed in supply); and, a tax on future investment in commercial property (less fixed). The extent to which the last part is fixed, likely varies between property types. For instance, it is difficult to obtain planning permission to build new shopping centres. By contrast, investment in upgrading out-of-town warehouses or factories is less likely to face hurdles from the planning system. As a result, high street retailers likely bear less of the burden compared to manufacturers.

If the burden ultimately falls mainly on commercial landowners as opposed to commercial tenants, then we should expect changes in Business Rates to be reflected in changes in rents. For instance, if the incidence fell solely on landlords then a rise in Business Rates will lead to a proportionate fall in rental cost, leaving total costs for occupants (Business Rates + Rents) unchanged.

The limited empirical evidence we have suggests that for retail the majority of the burden of Business Rates falls upon the commercial landowner rather than tenants. One study looked at the impact of the consolidation of multiple different local property taxes into the current system of centrally determined Business Rates on commercial rents in London. It found that boroughs, which saw a net increase in tax burden, saw rents for occupants fall by the same amount, and vice versa.[58]

More recent evidence from the British Property Federation found that Business Rates rises feed through into commercial rents, but this process is not instantaneous. Although commercial rental contracts have shortened over the past decade or so, many retailers will be locked into contracts for a number of years.[59] The British Property Federation analysis found that rents adjust by 75% within three years.[60] This painful process of adjustment may explain why rates revaluations are controversial. However, the pain is likely heightened by the infrequent

58. Nigel Medhi, "The capitalisation of business rates: An empirical study of tax incidence in six London boroughs", PhD thesis, London School of Economics and Political Science (2003).
59. George Hammond, "UK commercial leases shorten as crisis-hit tenants win concessions", *Financial Times*, August 17, 2020.
60. Regeneris Consulting, "Business Rates: Who Pays and Why it Matters" (2015).

nature of revaluations and the prevalence of upward-only rent review clauses. The recent shift to revaluations every three years[61] is welcome, but ideally revaluations would happen as frequently as possible.

If the incidence falls mostly, if not entirely, on commercial landlords, then Business Rates only advantage online retailers in the short-term; in other words, before rents adjust. It follows that large differentials in Business Rates bills are not sufficient grounds to create a special tax on online retailers, such as the online sales taxes advocated by some prominent retailers and currently under consideration by HM Treasury. There may be other justifications for singling out online retailers, such as the ability to take advantage of profit-shifting to reduce tax burdens, or the impact of deliveries on congestion and air pollution. However, in each case targeted measures such as reforms to Corporate Tax, as discussed in Chapter Two, would be a better approach.

Business Rates have survived as a tax despite frequent complaints from businesses, in particular high street retailers, because they are a significant revenue raiser. Before the pandemic, they brought in £25 billion each year.[62] As the incidence falls mostly, but not entirely, upon commercial landlords, there is substantial resistance within HM Treasury to abolition. If alternative taxes, such as Corporation Tax or Capital Gains Tax, were raised instead, it would likely have a net negative impact on productivity. Instead, recent Governments have preferred to keep the main structure of Business Rates intact, while creating carve-outs for small businesses and certain types of property (such as cinemas and pubs). However, there are limits to what ad hoc exemptions and reliefs can achieve. A longer-term solution based on clear principles is necessary.

In reforming Business Rates, we should adopt a strategy designed to shift the burden away from real business activity and onto rents deriving from land ownership. Utilising this approach would stimulate investment,

61. At least, in theory. In practice, the first revaluation under this system has been postponed to 2023.
62. Ministry for Housing, Communities, and Local Government, "Statistical release: Local Government Finance National non-domestic rates to be collected by local authorities in England 2021-22", https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1008667/NNDR1_21-22_Stats_release.pdf (2021).

create certainty for business, and protect tax revenues in the long-term.

Now we go on to outline the key problems with Business Rates that any proposals need to address. These key problems are: a bias against investment in business property; a bias against commercial use; and unnecessary complexity in administration.

## The bias against investment

Under the existing system, businesses which own the premises they operate from incur additional tax obligations when they invest in improving their property. For example, completing a £185 million rebuild of a blast furnace in 2013, led to Tata Steel's annual Business Rates bill at Port Talbot in South Wales rising by £400,000.

Although the majority of plants and machinery are not rateable, building berths, blast furnaces, coking ovens, cooling ponds, dams, cranes, flumes, generators, turbines, boilers, reservoirs, stills, tanks, vats and silos all do, as do many other types of industrial equipment. Unlike Corporation Tax, which taxes the return to investments in plants and machinery, Business Rates tax it regardless of whether or not it contributes to higher profits.

This bias not only has a negative impact on productivity, it also reduces the ability of businesses to make improvements to energy efficiency and invest in renewable energy.

In their summary of the responses to their Fundamental Review of Business Rates, HM Treasury noted that a difference in the way on-site and off-site energy generation was treated acted as a disincentive to investing in clear energy generation.[63] Although there is Business Rates relief available for investment in microgeneration, it was seen as insufficient for the larger investments that will be necessary to meet the UK's net zero objectives. Similarly, water companies have noted that investments in flood protection are also made more costly as a result of Business Rates.[64]

63. HM Treasury, "Business rates review: interim report", https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/971681/Fundamental_Review_Interim_Report.pdf (2021).
64. Ibid.

The impact on productivity is likely to be particularly pronounced when it comes to investments in improving the nation's infrastructure. Targeted exemptions, such as the Business Rates relief for investment in fibre-optic broadband, mitigate this, but there is still a clear disincentive to investing in our nation's infrastructure. For instance, BT, the National Grid, and Network Rail all face annual Business Rates bills of over £100 million per year. One Liberal Democrat policy paper asked the pertinent question: "why does the UK have a solar panel tax, a railway line tax, and a water infrastructure tax?"[65]

As well as discouraging investments in plants and machinery, Business Rates also discourage traditional property improvements. Although due to the restrictive nature of the planning system most landlords will build their permissions out fully, there will inevitably be some marginal projects that do not take place due to the cost of Business Rates.

The impact of the bias against investment, while hard to model, is substantial. In 2016, the OBR released an analysis showing that exempting all new investment in Class 4 Plants and Machinery (a category that includes masts, fixed cranes and tanks) from Business Rates would increase business investment by 0.5%, or £1 billion annually.[66] Going further, as advocated by Make UK, and fully exempting plants and machinery from Business Rates would have an even larger impact as it would also increase the competitiveness of manufacturers trading internationally and reduce the risk of capital-intensive business from closing their doors.[67]

## The bias against commercial use

As a share of GDP, the UK has the highest property taxes of the 36 nations in the OECD. The burden of property taxes is, however, not divided evenly

65. Adam Corlett, Andrew Dixon, Dominic Humphrey and Max von Thun, "Replacing business rates: Taxing land, not investment – Introducing the commercial landlord levy", https://d3n8a8pro7vhmx.cloudfront.net/libdems/pages/43666/attachments/original/1535625230/embedpdf_Autumn18_Business_Rates.pdf?1535625230 (2018).
66. The measure was removed from the 2016 Budget at the last minute, but made it into the OBR's Budget Forecast. Ibid.
67. Jim Pickard and Michael Pooler, "Budget plan to exempt new machinery from rates bill", *Financial Times*, February 29, 2016.

between residential and commercial property. In general, a property owner could substantially reduce their tax liability by converting a commercial property into a residential property.[68] The Government's proposed reforms to the planning system to make it easier to change use classes from class E (commercial, business and service) to residential will increase the housing stock and contribute to the vibrancy of high streets.[69]

However, they may have the unintended consequence of shifting the tax incidence of rates from landlords to businesses as the supply of commercial property becomes less fixed. This may be a partial motivation for large retailers such as John Lewis to convert unused shop space into housing.[70] In the long-run, this could create a powerful tax incentive, which hollows out high streets and create a backlash against otherwise sensible plans to make the planning system more dynamic.

In order to reduce the cost on certain businesses, there are an array of targeted Business Rates reliefs such as Small Business Rate Relief, Charitable Rate Relief, and Empty Premises Relief. These reliefs, while well-intentioned, create administrative challenges for local governments and can, in some cases, discourage business activity.

Their effectiveness at supporting SMEs or charities is limited by capitalisation. As the government's interim response to the Fundamental Review of Business Rates noted "Tenants often assess the total 'cost of occupation' as a single cost, meaning that rates and rents are likely to be traded off against one another in practice." SMEs or charities who receive a relief may use the relief to outbid other potential tenants. This would raise rents overall and lead to landlords capturing some of the benefits of the relief.

There is also a risk of 'francifaction' where hard-cut off points (or steep withdrawal rates) create an incentive for businesses to cluster

68. There are exceptions, for instance, if your commercial property attracts small rate relief then you may be better off keeping it commercial.
69. Cassie Barton and Gabrielle Garton Grimwood, "Planning in England: permitted development and change of use", https://commonslibrary.parliament.uk/research-briefings/sn00485/ (2021).
70. Dominic Brady, "Retail giant John Lewis eyes 20 sites as it plots expansion into social housing", *Inside Housing*, 16 October, 2020.

just below the threshold for the relief, limiting their ability to grow. Small Business Rate Relief has this feature, as does the Small Business Multiplier, as described in Box 3.1 earlier. Small Business Rate Relief may also encourage inefficient property use. For instance, some small businesses plan to switch to a three-days in the office per week arrangement. On balance, such an arrangement seems better suited to buying passes at a coworking space than renting a small office. However, a business would lose their relief if they were to move into a co-working space, which will have a total rateable value in excess of £15,000 (and likely in excess of £51,000). This puts co-working spaces at a competitive disadvantage and will, at the margin, lead to fewer of them as it is more efficient to subdivide.[71]

Charitable Rate Relief, as described in Box 3.1 earlier, may also create problems. The discount could be seen to grant charity shops a significant competitive advantage and may change the character of the high street. While charity shops, outside of a few cases, are unlikely to compete directly with for-profit high street retailers, it is likely that without the relief fewer will operate on the high street.

As the Portas Review into the future of our high streets noted, what we "want to see is diversity on our high streets. When a high street has too much of one thing it tips the balance of the location and inevitably puts off potential retailers and investors. Too many charity shops on one high street are an obvious example of this."[72]

Empty Property Relief, again explained in Box 3.1, allows landlords to claim relief from Business Rates for up to three months for vacant properties. The relief reduces Business Rates revenue in England by £800 million per year.[73] This creates an incentive for landlords

71. Enterprise Nation, "The impact of business rates on flexible workspaces and proposal for a relief", https://enterprisenation.blob.core.windows.net/enterprisenation/55499401eb55e911a97600224807251a/Enterprise%20Nation%20submission%20on%20flexible%20workspaces%20business%20rates%2002-04-2019-converted.pdf (2019).
72. Mary Portas, "The Portas review: an independent review into the future of our high streets", https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/6292/2081646.pdf (2011).
73. Corlett et al., "Replacing business rates".

to leave properties vacant for longer. They can 'renew' the relief by having the property temporarily occupied for six weeks. If this relief was removed, then it would create a greater incentive for landlords to fill vacant properties as soon as possible, increasing the supply of commercial property.

## Unnecessary complexity

Businesses often find navigating the Business Rates system complex. The array of reliefs available is one contributor, with some responses to the Fundamental Review of Business Rates noting that "complexity in the system can lead to ratepayers failing to understand their eligibility, or relying on external agents for support in navigating the system."[74] Additionally, the existing system of valuation is not easy to navigate and challenging a valuation can impose significant costs upon the time of small business owners in particular.

One potential solution would be to shift the responsibility for paying Business Rates from tenant to landlord. Under the status quo, a shopping centre or business park occupied by multiple businesses would generate separate business rates for each tenant. Currently, each individual business needs to learn how to navigate the system and is responsible for making appeals. By contrast, in co-working spaces only the landlord or property manager will handle the administration and payment of Business Rates. The businesses which buy memberships and rent spaces have no interaction with the Business Rate system. This has its downsides under the status quo as they do not benefit from Small Business Relief and were unable to apply for grants to cover their rent during the pandemic, but there would be clear advantages in terms of simplicity for applying this approach more broadly. Reliefs under a system where responsibility for payment of rates rested with the landlord could be designed to avoid this problem and eliminate the hidden bias against co-working businesses.

74. Ibid.

Just 39% of SMEs (excluding SMEs without premises) own their own premises.[75] In comparison, the commercial landlord sector is largely professionalised and most landlords own multiple premises. Landlords, unlike tenants, are less likely to change frequently. As a result, the administrative requirements will fall further.

## Recommendations for reforming Business Rates

**Recommendation five: Business Rates should be replaced with a Business Land Tax levied on commercial landowners, based on unimproved land values.**

If Business Rates are a combination of a highly efficient tax on unimproved commercial land and a distortive tax on improvements to commercial property, then a logical objective for reform would be to eliminate the latter tax and expand the former tax to make up the lost revenue.[76]

Moving from the existing system, which is based on property values, to a system based upon unimproved land values would represent a clear improvement. This approach, while technically difficult, is feasible. As summarised in the recent Bright Blue report Home Truths, a number of countries have separate taxes on land values, including Estonia, Denmark and Australia.[77] The key challenge for any land tax is to accurately estimate the value of land across the UK, which unlike property rents, are observed less frequently. However, it is possible to learn from the approach employed by other countries. On this front, Estonia would not be a model as it has not revalued the tax since 2001. Denmark and some Australian states, which update land values annually or bi-annually, offer a better guide to action. Over the past decade, online estate agents have been able to use data and machine-

75. Ibid.
76. Ireland and Italy are the only countries to have taken the opposite approach and only tax property improvements.
77. Cheshire and Hilber, "Home truths".

learning to estimate land and property values in a given area. While the estimates provided can be inaccurate or flawed on occasion, they provide a useful starting point. It is likely that technology will play an important role in any method of valuing land. As a result, moving to a fully digital and open land registry will be helpful.[78]

In their report, Replacing business rates: taxing land, not investment, the Liberal Democrats estimate a revenue cost of £2.2 billion in England and Wales if the current system of Business Rates was replaced with a Commercial Landowner Levy with a multiplier set at 59p and 67.5p in England and Wales respectively.[79] Since their estimate was made the Business Rate Multiplier has increased from 48p and 49.3p to 49.9p and 51.2p. This suggests a higher rate would be needed to maintain revenue neutrality; we estimate it would be 66p in England.[80] The Liberal Democrat proposal was a tax cut by design; there is no specific barrier to imposing higher multipliers to achieve revenue neutrality. The only potential limit is to avoid tax-motivated shifts from commercial to residential property, however the mechanism proposed further below would mitigate that.

Revenue estimates are highly sensitive to the rate of growth in land values, if land values continue to outpace inflation over the next five to ten years then significantly more revenue would be raised. For instance, the Liberal Democrat's modelling finds that if land values grow with Nominal Gross Domestic Product (NGDP) instead of Consumer Prices Index (CPI) over the next decade, then their £2.2 billion revenue losing multiplier would instead raise an additional £1.6 billion.

This proposal would maintain the existing Small Business Relief and Charitable Rate Relief by default, however, the new levy would remove the Empty Property Relief, raising an estimated £800 million per year in the long term. This change will likely increase the supply of commercial

78. GOV.UK, "Laying the foundations for a digital land registry", https://technology.blog.gov.uk/2019/02/26/laying-the-foundations-for-a-digital-land-registry/ (2019).
79. Ibid.
80. Author's calculations. An additional 3.85% is added to account for the higher multiplier and a further 8% is added to account for the £2.2 billion revenue loss.

property and reduce rents for businesses.

This reform would also reduce bureaucracy for the majority of businesses which do not own their own premises by shifting the legal responsibility for paying onto commercial landlords, who in many cases manage multiple properties.

It is important to note that shifting the legal incidence will not change the economic incidence. We expect the Levy to be passed on to tenants in the form of higher rents. However, unlike the status quo where capitalisation can be a painful multi-year process for businesses, as explained earlier in this chapter, the transitional costs of this will only be borne by landlords, opposed to tenants.

Under this proposal, land values would be determined by best possible (as in permitted by the planning system) commercial use. The rationale for this is that basing it on current use would create an incentive against switching to more productive uses.

By shifting the tax burden away from investment and towards unimproved land, this proposal would have a positive impact on productivity and, in turn, wages. As a result, it will in the long-term be a net progressive move. For instance, exempting new investments in Class 4 Plants and Machinery, as explained earlier in this chapter, alone would alone increase investment by 0.5%.

It would also have a positive impact on manufacturing as factories are typically built in areas with low land values. As a result, regions where manufacturing is a significant source of output and employment will benefit. It will also have a positive impact on regional inequality as land values are typically higher in London and the South-East.

This would represent a radical reform to the way business property is taxed in the UK, however as this Government itself admits, fundamental reform of the Business Rates system is necessary. Moving to a new system would not be an overnight process and may not be completed until the end of the Parliament. In the short term, some of the key benefits of fundamental reform can be accessed by exempting

plants and machinery from rateable values. In 2014, Make UK (then EEF) estimated this would cost £1 billion annually.[81] However, taxing any improvements whether they be plants and machinery, or adding an extra floor to an office space, correspond to a productivity loss, implying in the long-term term that reducing this burden would likely lead to long-term revenue gains from other taxes.

It should be noted that while this new system will be a substantial improvement over the status quo, it will not address every complaint. However, often Business Rates have become a scapegoat for more fundamental issues to do with the supply of property. The Government's proposals to reform and streamline the planning process will in the long run likely have a larger impact.[82]

**Recommendation six: To discourage tax motivated shifts from commercial to residential property, a new levy on commercial-to-residential transfers should be introduced.**

Over the past decade, there has been a significant liberalisation in the planning system with regards to use-class changes. In 2013, the right to convert offices to housing was granted across the UK (except in Central London and Manchester) and new planning laws came into force this year extending the right to convert high street shops into housing.

This is a necessary and appropriate response to both the shortage of affordable housing across the country and a way to stimulate activity on high streets. By granting property-owners the flexibility to change use-classes, assets are being put to their most productive use. One analysis, which studied 2,000 office transactions between 2009 and 2016, found that the right to change uses was associated with a 50% price premium.[83] There are likely to be similarly significant gains from

81. Pickard and Pooler, "Budget plan to exempt new machinery from rates bill".
82. See Paul Cheshire and Gerard H. Dericks, "'Trophy architects' and design as rent-seeking: quantifying deadweight losses in a tightly regulated office market", https://cep.lse.ac.uk/_NEW/PUBLICATIONS/abstract.asp?index=7343 (2020).
83. Paul Cheshire and Katerina Kaimakamis, "Offices scarce but housing scarcer: estimating the premium for London office conversions", https://cep.lse.ac.uk/_NEW/PUBLICATIONS/abstract.asp?index=7105 (2020).

the ability to convert shops into homes.

It is important, however, to ensure that office or shop conversions are motivated by economic fundamentals and not by tax efficiency. The key issue here is that taxes on commercial property are significantly higher than taxes on residential property. For example, a commercial property with a rateable value of £51,000 would pay £26,112 in Business Rates. By contrast, if the commercial property were subdivided into five houses then the combined annual Council Tax burden would fall to £7,000.[84]

Without an appropriate backstop, there is a risk that a well-intentioned productivity-enhancing policy will backfire by creating a powerful tax incentive to convert office and retail space. If projects are being selected based on tax rather than market conditions, then it is likely to exacerbate concerns around 'rabbit-hutch' homes.[85] It may even create political pressure to remove the right altogether, if it is seen to be failing to restore activity to high streets.

There is an economic cost too. If there is a powerful incentive to reduce the supply of commercial property through change-of-use, then the burden of Business Rates will fall upon businesses rather than landlords through higher rents. This will increase occupancy costs and reduce the efficiency of the tax, reformed or otherwise.

To prevent this from occurring, we propose a new levy on commercial-to-residential transfers. Commercial landlords converting their property would be forced to make up the difference between Business Rates (or Commercial Land Levy) and Council Tax. Payment would be flexible, landlords could choose to pay ten years worth of payments up front, or alternatively pay the full annual rate for fifteen years.

This policy is designed to achieve two aims. First, it will ensure that the burden of taxes on commercial property falls upon landlords and not their tenant businesses. Second, it will prevent the gradual erosion

84. The average Band C rate is £1,400.
85. GOV.UK, "Relaxation of planning rules for change of use from commercial to residential", https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/8492/2172423.pdf (2012).

of the commercial property tax base through use-class changes.

**Recommendation seven: Responsibility over Business Rates reliefs and exemptions for Small Businesses, Charities and Agriculture should be devolved to local authorities.**

Moving to a new system of a Business Land Tax is likely to be difficult in transition for administrative and political reasons. To mitigate potential objections, existing tax reliefs in Business Rates targeted at small businesses, charities, and agricultural land – as outlined in Box 3.1 much earlier – should be preserved. Under the new system, tenants should still be able to apply for the relief and it would be paid directly in proportion to the landlord's Business Land Tax payment. This would mitigate the risk that small businesses and charities see their total occupancy costs increasing as landlords pass rents on.

However, the existence of reliefs for SMEs, charities, and agriculture do create additional complexity. There is also the prospect of capitalisation, which would mean that the full benefits do not always flow to their intended targets. The existing Business Rates system also provides reliefs to business irrespective of need.

This presents an opportunity to further empower local governments to take more control over their high streets and commercial centres. Devolving responsibility over exemptions and reliefs to local authorities would allow the people best placed to understand their impact to determine their shape.

Local authorities would have the freedom to remove or restrict reliefs, if they believe they were able to better use the money to support local priorities. For instance, they may decide to create their own locally administered Community Ownership Funds to save local theatres, pubs and sports clubs. They might also decide they want to fund charities or social enterprises that work in the community directly rather than support them indirectly through business rate relief. In the case of Small Business Relief, they might use additional funds to open incubators or accelerators, or fund business mentoring programmes.

This would be an extension of the existing approach to Charitable Rate Relief, where the relief is set at 80% by central government but local authorities have discretionary powers to top it up to 100%.

In some cases, reliefs may have unintended consequences. For instance, Charitable Rate Relief may harm the vibrancy of high streets leading to an overabundance of charity shops in one area. To correct for this, one additional power local authorities should be granted is the ability to cap the number of Charitable Rate Reliefs in a given area.

This policy would also give local authorities the freedom to limit discounts and reliefs to a specific geographic area. For example, a high street or shopping district with a reputation for having a high proportion of independent shops would be able to keep Small Business Relief for that area alone and would be able to use the revenue from removing exemptions elsewhere to invest in transport links to the area.[86]

There may be a risk that allowing local authorities to remove or restrict reliefs would lead to fewer reliefs disproportionately in lower income areas. However, it is possible to mitigate this risk in a number of ways. First, councils should only capture the upside from removing reliefs. At the moment, if councils want to grant additional discretionary reliefs for charitable purposes they receive 50% support from central government. However, under this system they would each receive full funding for the entire relief, but would have the flexibility to remove or restrict in any other way. This policy will not leave any local authority in a worse-off financial position, but would provide greater flexibility to address local problems. Second, additional conditions could be placed on what councils use from funds deriving from relief restrictions. For example, the independent Grimsey Review into the high street suggested that mandatory Charitable Rate Relief ought to be cut to

86. For example, Brighton and Hove Council may value independent shops in the North and South Laines areas over and above other areas as those areas attract tourists. They could limit Small Business Relief at full value to those specific business districts and then use the remaining revenue saved to grant additional reliefs in those areas under their Localism Act 2012 powers.

70%, but the discretionary 30% should be put into a ringfenced pot for projects that benefit the community.[87] Similarly, any revenue derived from lower levels of Small Business Rates Relief could be ring fenced for projects designed to increase business activity such as improved transport to the central business district or for support for institutions that support small businesses such as incubators or accelerators. Restrictions could be made more or less strict based on the Government's preference for localism.

There is also a risk that reform distorts economic activity by treating similar businesses in different parts of the country differently. But this is an inevitable cost to any devolution of tax policy and outweighed by the benefits of greater local democratic control. Instead of a one-size-fits-all 'Whitehall knows best' approach, this would empower people with local knowledge to solve problems within their community.

87. Bill Grimsey, "The Grimsey Review: An Alternative Future for the High Street", http://www.vanishinghighstreet.com/wp-content/uploads/2016/03/GrimseyReview04.092.pdf (2016).

# Chapter 4:
# Understanding and reforming targeted tax reliefs

This chapter unearths a range of targeted business tax reliefs designed to encourage businesses to invest, engage in R&D, operate in specific sectors, and attract growth capital. This chapter does not discuss structural elements of taxes, such as capital allowances, or Business Rates reliefs, as they have already been covered in the last chapter. The chapter goes on to outline the flaws with selected business tax reliefs and outlines principles for reform.

## Business tax reliefs in context

At the moment, policies designed to promote some activity, such as employment, entrepreneurship or research, tend to receive less scrutiny when they are framed as tax breaks as opposed to direct spending. For example, it is hard to imagine that the public would endorse a £22 million grant to Disney to film a Marvel movie in London, yet the business tax relief equivalent attracted relatively little controversy.[88]

Over the past two decades, a range of targeted tax reliefs designed to influence business activity, such as engaging in research and development, or performing certain activities that are seen to be internationally mobile, such as film production. In some cases, the reliefs are designed to alleviate costs on smaller businesses or to attract investment into innovative businesses. Many reliefs, such as the R&D Tax Reliefs and Creative Tax

88. BBC, "Thor: The Dark World claims £22m UK tax rebate", *BBC News*, 8 July, 2014.

Reliefs, provide credits that can be offset against Corporation Tax for certain expenditures. In the case of the Patent Box, it simply provides a lower rate of Corporate Tax for income generated from patented activity. However, business tax reliefs also interact with personal taxes. For instance, the Venture Capital Tax Reliefs support early-stage innovative businesses by providing Income and Capital Gains tax reliefs to investors. Likewise, the Employment Allowance offers relief for Employers' National Insurance Contributions to support employment.

Many of the tax reliefs discussed in this chapter, and summarised in Box 4.1 further below, were expanded under the Conservative-Liberal Democrat Coalition Government in the early 2010s. For instance, the Enterprise Investment Scheme and Venture Capital Trusts (investment reliefs designed to stimulate investment in early-stage entrepreneurial businesses) were joined by the similar, but more generous Seed Enterprise Investment Scheme targeted at the earlier-stage business in 2012, and Social Investment Tax Relief targeted at social enterprises in 2014. Similarly, Employment Allowance, which provided £4,000 in Employers NICs relief for smaller businesses was introduced in 2014. While Film Tax Relief was introduced in 2007, the range of creative industries tax reliefs were expanded under the then Chancellor George Osborne in 2013 to cover video-games, museums, theatres, and high-end TV.

The most significant debate around business tax reliefs has been over the scope of the Research and Development Tax Reliefs, coincidentally the largest reliefs by far. In 2021, an exasperated former Prime Minister Theresa May remarked in Parliament: "We are to see another consultation on R&D tax credits—I believe it is the third in three years. I have to say to him: stop consulting, just get on and do something."[89] At the most recent Budget, current Chancellor Sunak announced an expansion in the scope of R&D Tax Credit to cover more modern types of R&D.

The lack of scrutiny is stark when you consider that some reliefs dwarf departmental budgets. If the Employment Allowance, described below, was

89. Theresa May, *Debate on budget resolutions and economic situations*, 9 March, 2021.

a government department, it would be larger than the Department for Environment, Food, and Rural Affairs – and on par with the Foreign Office (at least before it was merged with DfID). Significantly, it is an intervention that Stuart Adam of the IFS described as "almost impossible to evaluate."[90] For perspective, the annual cost of this Government's flagship employment policy, Kickstart, at an estimated £1.26 billion, is lower.[91] It seems likely that a scheme targeted at young people at risk of long-term unemployment would represent better value-for-money than the Employment Allowance, which will provide relief mostly for jobs that would exist anyway.

Business tax reliefs play an important role in the UK's innovation policy. Each year, Research and Development Tax Credit costs the Exchequer over £7 billion. Similarly, over £1 billion per year is claimed by businesses using the Patent Box, a corporate tax relief that allows businesses with income from patentable Intellectual Property (IP) to pay a 10% rate of Corporation Tax.[92] This figure is likely to grow significantly when the Corporate Tax rate rises to 25% in 2023. There are also numerous targeted tax reliefs designed to stimulate investment into early-stage innovative businesses such as Enterprise Investment Scheme (EIS), Seed Enterprise Investment Scheme (SEIS) and Venture Capital Trusts (VCTs). There is evidence they have a positive impact on the UK's startup ecosystem and address market failures, but they also provide large tax benefits to investors who are likely to be well-off.[93] The generosity of such corporate tax reliefs often creates a need to prevent abuse, which in turn generates red tape and complexity for businesses using the relief as intended.

In the search for additional revenue after COVID-19, it is likely that corporate tax reliefs will come under increased scrutiny in the coming years.

90. Antony Seely, "National Insurance Contributions Bill", https://researchbriefings.files.parliament.uk/documents/RP13-60/RP13-60.pdf (2013).
91. Bethan Staton and Delphine Strauss, "UK's Kickstart jobs scheme underdelivers, says audit office", *Financial Times*, 26 November, 2021.
92. HMRC, "Patent Box relief statistics", https://www.gov.uk/government/statistics/patent-box-reliefs-statistics#full-publication-update-history (2022).
93. Jimmy McLoughlin, "Opening the equity economy", https://www.iod.com/Portals/0/Badges/PDF's/News%20and%20Campaigns/Enterprise%20and%20business%20environment/Opening%20the%20equity%20economy.pdf?ver=2016-04-14-101147-367 (2015).

**Box 4.1. Targeted business tax reliefs**

| Name of Relief | Description | Revenue Cost[94] |
|---|---|---|
| Research and Development Expenditure Credit (RDEC) | RDEC is calculated at 13% of a company's qualifying R&D expenditure and is taxable. | £3.1billion |
| SME R&D Relief | SME R&D relief allows companies to:<br>• deduct an extra 130% of their qualifying R&D costs from their yearly profit, as well as the normal 100% deduction, to make a total 230% deduction.<br>• claim a tax credit if the company is loss making, worth up to 14.5% of the loss. | £4.4billion |
| Patent Box | Applies a lower rate of Corporation Tax (10%) to profits earned from its patented inventions. | £1.13billion |
| Employment Allowance | Employment Allowance allows businesses with Class 1 National Insurance liabilities less than £100,000 in the previous tax to reduce their annual National Insurance liability by up to £4,000. | £2.1billion |

94. All data is from HMRC, but in the case of the venture capital schemes (EIS, SEIS, SITR, and VCTs) estimates are taken from HRMC's Estimated Costs of Principle Tax Reliefs publication.

| | | |
|---|---|---|
| Enterprise Investment Scheme | Offers Income and Capital Gains tax reliefs to individuals investing in businesses with:<br>• no more than £15 million in gross assets.<br>• fewer than 250 employees.<br>• no more than 7 years since its first commercial sale. | £600million in Income Tax relief plus a share of £120m Capital Gains Tax relief |
| Seed Enterprise Investment Scheme | Offers greater Income and Capital Gains tax reliefs to individuals investing in businesses with:<br>• no more than £200,000 in gross assets.<br>• less than 25 employees.<br>• not previously carried out a different trade. | £105million in Income Tax relief plus a share of £120m Capital Gains Tax relief |
| Social Investment Tax Relief | Offers Income and Capital Gains Tax relief for investors in social enterprise where the social enterprise has:<br>• no more than £15 million in gross assets.<br>• fewer than 250 employees. | N/A (Below £3.3million) |

| | | |
|---|---|---|
| Venture Capital Trusts | Offers Income and Capital Gains Tax relief for investors in VCTs who invests in, or lends money to, unlisted companies that meet the following conditions:<br>• no more than £15 million in gross assets.<br>• less than 250 employees.<br>• not been more than 7 years since its first commercial sale. | £175million |
| Film Tax Relief | Film productions made in the UK can claim back a cash rebate worth up to 25% tax relief on qualifying UK production costs for Corporation Tax. | £611million |
| High End TV Tax Relief | Certain High End TV productions (minimum cost per hour long episode of £1million) made in the UK can claim back a cash rebate worth up to 25% tax relief on qualifying UK production costs for Corporation Tax. | £380million |

| | | |
|---|---|---|
| Video Games Tax Relief | Video games made in the UK can claim back a cash rebate worth up to 25% tax relief on qualifying UK production costs for Corporation Tax. | £180million |
| Theater Tax Relief | Theater productions can claim back a cash rebate worth up to 20% (25% for touring productions) tax relief on qualifying UK production costs for Corporation Tax. | £74million |
| Orchestra Tax Relief | Orchestras can claim back a cash rebate worth up to 25% tax relief on qualifying UK production costs for Corporation Tax. | £11million |
| Museums and Galleries Tax Relief | Museums and galleries can claim back a cash rebate worth up to 20% (25% for touring exhibitions) tax relief on qualifying UK production costs for Corporation Tax. | £14million |
| Animation Tax Relief | Qualifying animated productions can claim back a cash rebate worth up to 20% (25% for touring productions) tax relief on qualifying UK production costs for Corporation Tax. | £18million |

## Principles for business tax reliefs

Taxes can act as a powerful financial incentive to modify behaviour. It is to be expected then that governments will try to use the tax system to influence economic activity and achieve policy objectives. One reason why business tax reliefs proliferate is that politicians sceptical of the effectiveness of public spending often hold tax relief to weaker standards of scrutiny.

Markets often fail due to externalities, asymmetric information, or monopoly power. In certain circumstances, there is a strong case for using the tax system to correct these failures. For example, taxes on pollution or congestion (known as 'Pigouvian Taxes') are a well-established tool for policymakers. Similarly, when something is under-supplied by the market, targeted tax-breaks can improve efficiency.[95]

The UK is a relative high-spender in terms of tax reliefs, in general. According to the Global Tax Expenditure Database, targeted tax reliefs make up 7.5% of GDP in the UK. This is well above the global average, which has varied between 3.3% and 4.9% over the past 30 years.[96] However, this is primarily driven by the UK's proliferation of VAT reliefs and exemptions.[97]

Targeted tax reliefs are not always the most effective tool for achieving policy goals. Multiple conditions need to be met to prefer a tax relief to using regulation or public spending directly.

1. **Only act when there is a clear market failure.** In the absence of a well-defined market failure, tax reliefs will distort market behaviour away from the socially optimal outcome. As Helen Miller of the IFS argues: "Wanting more robots or small businesses or UK-made films because they're 'good' in some way isn't a sound

95. For the purposes of this report, we separate tax expenditures from structural features of the tax system such as loss carryforwards, capital allowances, and de minimis thresholds.
96. Agustin Redonda and Christian von Haldenwang, "Tax expenditures: The hidden side of government spending", https://voxeu.org/article/tax-expenditures-hidden-side-government-spending (2021).
97. Tom Clougherty, Daniel Bunn, Elke Asen, and James Heywood, "A framework for the Future: Reforming the UK Tax System", https://files.taxfoundation.org/20201023134831/A-Framework-for-the-Future-Reforming-the-UK-Tax-System-PDF.pdf (2020).

enough rationale. If they're good, why won't the current market create the number of robots or films that balance the overall costs and benefits to society?"[98]

2. **Reliefs should be frequently evaluated.** Tax reliefs can be significant budget items. In the case of R&D Tax Credit, it can be upwards of £5 billion a year, which is larger than many government departments. We would not normally tolerate such significant sums being spent without frequent and in-depth evaluation.. A National Audit Office report from 2020 notes that each year the government spends £150 billion per year on tax reliefs in total (individual and business) to support government objectives, but government has published evaluations of just £11 billion of it.[99] Furthermore, the quality of evidence used by HM Treasury is variable and no relief meets their gold standard of evaluation. The NAO recommend that evaluations should consider the following: deadweight loss and avoidance; consideration of spending alternatives; comparison of cost to forecast;[100] quantitative evi dence for cost-benefit ratio; quantitative evidence for outcomes and behaviour change; and, quantitative evidence for value-for-money assessment. The way tax reliefs are designed often affects our ability to evaluate them successfully. For example, Stuart Adam of the IFS criticised the design of the Employment Allowance as there was "no way of estimating what that impact will be, and I fear that we will never know."[101] Tax reliefs with designs that resist evaluation should be avoided.
3. **Only use tax reliefs when there is a strong case that they will be more effective than comparable spending.** The final test for any tax relief should be whether or not the same goal could be achieved more efficiently through direct government spending.

98. Helen Miller, "Should we build industrial strategy into tax design?", https://www.taxjournal.com/articles/should-we-build-industrial-strategy-into-tax-design- (2019).
99. National Audit Office, "The management of tax expenditures", https://www.nao.org.uk/wp-content/uploads/2020/02/The-management-of-tax-expenditure.pdf (2020).
100. For example, the forecast cost of the High End TV was less than half of its actual cost.
101. Seely, "National insurance contributions bill".

For example, there is an economic case for a targeted tax relief for training expenses, but there are risks that the scheme will be abused and the relief will benefit hobbyists attending recreational courses. In such a case, targeted funding for pre-approved courses may be a more effective measure.[102] A key advantage of direct funding is that tax incentives create additional complexity within the wider tax system and create an incentive to rebadge existing activity to qualify. Generally, targeted tax reliefs – or Pigouvian taxes – are effective at solving externality problems. By contrast, such taxes or tax reliefs are rarely the right tool to address monopoly power or barriers to entry.

## Recommendations for reforming business tax reliefs

The recommendations below affect the following tax reliefs:

- Patent Box
- Film Tax Relief and High End TV Tax Relief
- Research and Development Tax Credits
- Employment Allowance
- Venture capital schemes such as the Enterprise Investment Scheme (EIS), Seed EIS, Venture Capital Trusts, and Social Investment Tax Relief.

The listed reliefs are chosen because they are largest business tax reliefs that are the largest non-structural business tax reliefs, that is to say they are not fundamental features of the tax in the way that capital allowances are. The recommendations do not cover any Business Rates reliefs such as Small Business Rates Relief as they are already addressed in the previous chapter.

**Recommendation eight: The Patent Box should be abolished.**

Innovation is the fundamental source of economic growth, yet there are

102. On the other hand, this approach may reduce flexibility and crowd out private provision.

good reasons to believe that investment in research and development are underprovided in the marketplace. One issue is that innovators rarely capture a large share of the benefits from innovation.[103] The Nobel Prize winning economist William Nordhaus estimates that innovators capture just 2% of the global benefits of innovation. An extreme example of this is the market movement in response to the announcement of Pfizer's vaccine trial success. While Pfizer's share price jumped by 10%, the wider stock market jumped by around 3%.[104] The benefits spilled over to all firms and Pfizer only captured a small fraction. Patents are a powerful tool to increase innovation by helping innovators to capture a larger share of the economic returns from innovation.

As a result, in 2013, the Patent Box was introduced. It offered a lower rate of Corporate Tax (10%) for profits relating to the exploitation of patented inventions. As of 2020, the Patent Box reduces tax revenue by £1.1 billion. However, the planned rise in Corporation Tax to 25% in 2023 will substantially increase the tax advantage for patented inventions by two-thirds. Assuming that the same companies as at present make use of the relief, this alone would raise the cost of the relief by an additional £733 million to £1.83 billion. Additionally, the higher rate of relief should lead to some increase in the number of firms and amount of activity that qualifies for the Patent Box.

Yet, despite a large fiscal cost the case for a special low rate of Corporate Tax on patents is weak. First, patents are already a way of incentivising innovation by allowing inventors to capture spillovers. In theory, the spillovers that are hardest to capture, such as non-patentable innovations, are a more appropriate target. As an IFS paper on the Patent Box noted: "If the argument for subsidising R&D and innovative activities is that they create spillovers and public goods in the form of knowledge, it seems odd to encourage firms to direct their efforts toward

103. William Nordhaus, "Schumpeterian Profits in the American Economy: Theory and Measurement", https://www.nber.org/papers/w10433 (2004).
104. Statista.

patentable inventions."[105] At the margin, this may promote unnecessary patenting so firms can access the relief, creating zombie patents, that is, patents which would not survive if challenged in court.

Second, the relief is ex post (only covering successful innovations) rather than ex ante (subsidising the initial research). This creates multiple disadvantages as it can be difficult to assign income to a specific patent and creates an incentive to shift costs to high tax areas. As the policy rewards successful businesses, rather than supporting research by SMEs, the vast majority (over 90%) of the relief flows to large businesses.[106]

The empirical evidence on Patent Boxes is mixed, but in general negative. While there are studies that find a modest positive impact on invention and limiting base erosion,[107] the best evidence suggests that Patent Boxes are an ineffective way to promote innovation.[108] For instance, an IFS paper finds that while there is some impact on international patent transfers, there is no impact on invention.[109] As the impact appears to be predominantly associated with international tax competition, opposed to stimulating real activity, there are strong reasons to lobby for the elimination of Patent or IP Boxes internationally.

The abolition of the Patent Box would raise at least an estimated £1.8 billion per year from 2023 onwards.

**Recommendation nine: The Film Tax Relief and High End TV Tax Relief should be abolished.**

The UK's creative industries are an important source of economic activity. One of the measures employed to promote their development are targeted tax reliefs such as Film Tax Relief and High End TV Tax Relief. They allow productions made in the UK to claim back a cash rebate worth up to 25% tax relief on qualifying UK production costs.

105. Fabian Gaessler, Bronwyn H. Hall and Dietmar Harhoff, "Should there be lower taxes on patent income?", https://ifs.org.uk/uploads/publications/wps/WP201819.pdf (2018).
106. HMRC, "Patent Box relief statistics".
107. Eric Ohrn, "The effect of IP box regimes on international IP payments and foreign research and development", https://ericohrn.sites.grinnell.edu/files/IP_Box/IP_Box_8_2016.pdf (2016).
108. Gaessler et al., "Should there be lower taxes on patent income?".
109. Ibid.

The reliefs were justified under EU State Aid rules for promoting the production of culturally British films and each production must pass a specific cultural test to qualify. Without the link to culture, it is unlikely that the large reliefs would be considered legal.

In some cases, the link to British culture appears stretched. For instance, Disney has received £31 million to film parts of Avengers 2 in the UK, a film not set in the UK and with few British characters. There may even be a risk of displacing culturally British films. The director Edgar Wright notes: "While the tax break is good for Hollywood films shooting here, it's probably not that great for British films shooting in the UK. Some middle-to-low budget films are going to find themselves without crew because all the American films are shooting here."[110]

There are also large deadweight losses to any film tax relief scheme. For instance, an analysis of California's film tax credit found that one in three films would have been filmed in California even if they did not receive the tax credit.[111] As the UK's Film Tax Relief is not capped, the main beneficiaries of the relief will be major international film production companies. In the case of the UK's High End TV Relief, however, productions with budgets under £1 million per episode are explicitly excluded.

There may be a case for supporting the creative industries as part of our industrial strategy. In particular, the presence of international productions may provide useful training and opportunities to young people entering the industry. However, more targeted funding for BBC or BFI training programmes may achieve this objective at a significantly lower fiscal cost than the Film Tax Relief or High End TV Tax Relief. Industry estimates typically suggest unrealistically large multipliers for targeted tax credits, but neutral analyses find significantly lower benefits once crowding out effects are taken into account. For instance, an analysis of California's Film and Production Tax Credit found it

110. Christian Sylt, "Avengers 2: Disney handed record £31m tax credit for filming in UK", *The Independent*, 9 October, 2014.
111. Michael Thom, "Time to Yell "Cut?" An evaluation of the California film and production tax credit for the motion picture industry", *California Journal of Politics and Policy* (2021).

had no effect on motion picture employment in the state.[112] A wider analysis by the same author of 40 US state credits found no impact on motion picture industry concentration, no employment effect, and only a temporary wage effect.[113]

The Film and High End TV reliefs have cost significantly more than forecast when they were introduced. For instance, the Film Tax Relief was estimated to cost £327 million per year, but cost £522 million in 2019-2020. Similarly, the High End TV Relief cost more than twice (167%) as much as initially forecast, costing £324 million in 2019-2020. These two reliefs represent almost four-fifths of the revenue loss from all creative industry tax reliefs.[114]

The abolition of Film Tax Relief and High End TV Tax will increase tax revenue by at least an estimated £0.8 billion.

**Recommendation ten: The Employment Allowance should be phased out over the next five years.**

The Employment Allowance allows employers with Class 1 National Insurance Contributions (NICs) liabilities of £100,000 or less to claim up to £4,000 to reduce their NICs liability. It was introduced initially at a rate of £2,000, but has gradually risen to £4,000. The aim of the policy is to support employment among small businesses.

In general, evaluations of this relief are scarce and the quality of evidence available is weak. But the available evidence is not promising. The National Audit Office found limited evidence of the Employment Allowance's impact on employment. Noting that just "27% of employers claiming the allowance had or intended to use it for a specific purpose, such as more spending on staffing."[115] Of these

112. Michael Thom, "Lights, camera, but no action? tax and economic development lessons from state motion picture incentive programs", *The American Review of Public Administration* (2018), 33-51.
113. Thom, "Lights, camera, but no action?".
114. HMRC, "Creative industries statistics: August 2021", https://www.gov.uk/government/statistics/creative-industries-statistics-august-2021 (2021).
115. HMRC, "Awareness and impact of the Employment Allowance – Research with small employers", https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/445848/Research_Report_368_Awareness_and_Impact_of_the_Employment_Allowance_-_Research_with_small_employers.pdf (2015).

employers only 22% said the spending would not have taken place were it not for the allowance.

The Employment Allowance is a substantial tax relief reducing revenue from National Insurance contributions by raising £2.6 billion per year. For context, it is more than twice as large as the Government's flagship job creation scheme Kickstart. While it is likely to have an impact at the margin, the cost per job created is likely to be high. It seems likely that schemes targeted at employees with a high risk of unemployment, such as the Kickstart Scheme, are likely to have a greater impact on employment than an indiscriminate relief.[116]

There may also be a threshold effect where employers with Class 1 NICs liabilities just under the threshold face an extra £4,000 in tax from taking on a new employee. This could have a negative impact on hiring, or may create a cliff-edge effect where modest pay rises incur large costs.

The key barrier to reform is likely to be symbolic. As Baroness Neville-Rolfe argued in a Lords debate: "The most important thing about the employment allowance is totemic: it backs small business and enterprise and keeps people working."[117] Removing the allowance may send the wrong message at a time when many businesses are struggling. However, the purpose of tax reliefs should not be to send messages, but to influence behaviour.

Preserving the Employment Allowance over the next two years while the economic recovery is uncertain but phasing it out over the course of the following three will raise at least an estimated £2.6 billion. In future, employment support schemes should be targeted more directly at groups with high risk of unemployment.

116. The Kickstart Scheme is estimated to have 50% additionality, in other words half the scheme's participants would not have found work otherwise. The Department for Work and Pensions estimates that the scheme would have a positive social value if additionality was as low as 30%.
117. Hansard, "Employment Allowance (increase of maximum amount) regulations 2020 – motion to take note", https://www.theyworkforyou.com/lords/?id=2020-05-05d.403.0 (2020).

**Recommendation eleven: Venture capital reliefs such as Enterprise Investment Scheme, Seed Enterprise Investment Scheme and Venture Capital Trusts should be maintained at current levels and the process for qualifying and accessing these reliefs should be streamlined in line with the Office for Tax Simplification's proposals.**

Venture capital tax reliefs such the Seed Enterprise Investment Scheme (SEIS), Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) are designed to increase the supply of capital flowing to early-stage innovative businesses. The schemes have a long-history with John Major's Conservative Government introducing EIS in 1994 and VCTs in 1995 in order to help viable early-stage business to attract private equity funding. The schemes were revamped in 2011 by then Chancellor George Osborne, and an additional scheme, SEIS, was introduced to support early-stage startups.

Start-ups typically lack collateral and trading histories. As a result, investors must undertake costly due diligence which may not be justified by the size of the investment. The three schemes above effectively subsidise investments where this problem is likely to be acute. The subsidies are typically large, generating substantial tax savings for investors and significantly de-risking investments.

As a result, there are a range of anti-avoidance measures associated with the reliefs to prevent abuse. Most recently, a risk-to-capital measure was introduced "to remove investment arrangements based on capital preservation and ensure that the EIS and other tax-advantaged venture capital schemes are focused on investment in early-stage companies."[118]

The measures, while in many cases necessary, make the administration of the tax significantly more complex. Startups will typically be unable to access investment unless they can obtain Advance Assurance from HMRC that their investment will qualify for the relief. Startup

118. HMRC, "Enterprise Investment Scheme Seed Enterprise Investment Scheme and Social Investment Tax Relief", https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/887546/May_2020_Commentary_EIS_SEIS_SITR_National_Statistics.pdf (2020).

founders report that while HMRC intends to process applications within 14 days, waits of six to eight weeks are not a rare occurrence.[119] For startups with limited access to capital and high burn rates, delays can have a damaging impact, forcing them to delay hiring or in some cases, pause research projects.[120]

The complexity associated with applying for Advance Assurance can force many startups to seek external paid advice. Some issues with the process seem straightforward to address, for instance the Office of Tax Simplification points out that online applications cannot be saved forcing duplication of labour in cases where connection is lost.[121] Some problems are better understood as matters of resourcing. For instance, the requirement that applicants for Advanced Assurance name an investor was designed to deter speculative applications and reduce backlogs. However, some entrepreneurs report that it creates a Catch 22 scenario where investors are reluctant to talk unless they are confident the startup qualifies for the relief.

One way to reduce the administrative burden for the tax would be for HMRC to work with organisations such as the British Venture Capital Association to create pre-approved standard Articles of Association, to fast-track applications using the pre-approved standard, and to allow 'honest mistakes' to be corrected after the fact. This would enable low-risk applications to outsource applications to accredited advisors.

There is a stronger case for preserving SEIS, EIS and VCTs relative to other tax reliefs. The National Audit Office notes "schemes were generally working as intended in terms of how investments were used (for example, bridging finance gaps), and 60% of investors said their proposed investment would either definitely or probably not have taken place without the Schemes."[122] Similarly, a Deloitte and Business

119. Sam Dumitriu, "Unlocking growth", https://static1.squarespace.com/static/58ed40453a04116f46e8d99b/t/5e66b7ab657f600989b57cf1/1583790032369/Unlocking+Growth.pdf (2020).
120. Ibid.
121. Office for Tax Simplification, "Capital Gains Tax Review: Simplifying by design", https://www.gov.uk/government/publications/ots-capital-gains-tax-review-simplifying-by-design (2020).
122. National Audit Office, "Tax reliefs", https://www.nao.org.uk/wp-content/uploads/2014/03/Tax-reliefs.pdf (2014).

Angels Association report found three-quarters (74%) of business angels believed the reliefs were a key factor in their decision to invest and more than half would not have invested (or invested less) if they were not available.[123]

**Recommendation twelve: Social Investment Tax Relief should be preserved, but more resources should be invested in promoting the relief.**

Social Investment Tax Relief (SITR) is a close relative of the other venture capital schemes and is designed to support investment into social enterprises. Yet, it has seen modest take-up. For instance, when it was introduced it was estimated to cost up to £35 million per year, but only cost £2 million for its first three years of operation.[124] A key issue is a lack of awareness. One survey of 4,200 accountants found awareness of the relief was extremely low.[125] One problem may be an excessive focus on mirroring commercial schemes, such as EIS, when social enterprises typically have very different characteristics to high growth tech startups. However, there are success stories where SITR has allowed social enterprises to expand and help more people. For example, Ability Tech Community Interest Company (CIC), which grew out of the closure of Bolton's Remploy Electronics operation and provides employment opportunities for people living with disabilities, used a SITR loan to double their headcount.[126]

There is a case for preserving SITR as is, but investing modest sums in promotion, given the limited fiscal cost. For example, outreach could be targeted at accountants who already work with charities as well as organisations who incubate social enterprises. SITR may then be better understood not as a key driver of investment in social enterprises, but as

123. Ibid
124. AAT, "Association of Accounting Technician's response to the HM Treasury Call for Evidence on Social Investment Tax Relief", https://www.aat.org.uk/prod/s3fs-public/assets/Consultation-response-social-investment-tax-relief-call-for-evidence.pdf.
125. Ibid.
126. Tom Hopkins, "Understanding Social Investment Tax Relief and how to make it work", *FT Adviser*, 10 July, 2018.

a tool to ensure that social enterprises with high growth ambitions can benefit from similar tax reliefs available to more commercial ventures.

**Recommendation thirteen: The scope of qualifying expenditures for R&D Tax Credit should be expanded to include cloud, data, and User Interface/User Experience costs as announced at the 2021 Autumn Budget.**

The Research and Development Expenditure Credit (RDEC) and SME R&D Relief are substantial tax expenditures costing an estimated £7.3 billion per year.[127] They have been described by entrepreneur and economist David Connell as "the UK's flagship industrial policy."[128] Across the OECD, only France provides more tax support for R&D as a share of GDP than the UK.[129]

The theoretical economic case for R&D tax credits is that research and development projects often have positive spillovers and as a result are underprovided by the market. One reason is that failed projects still may resolve some uncertainty, which can in turn allow a competitor to profit. Similarly, in the case of non-patentable innovation such as software, competitors may be able to copy or reverse engineer innovations. A subsidy to R&D is a way to bring the private return in line with the social return

The impact of R&D tax credits is disputed. A recent and influential study by David Connell argued that the relief should be considered a failure, because as a "percentage of national income, self-funded BERD – in other words, R&D spending net of the government subsidy – is estimated to be between 10% and 15% lower than before R&D tax credits were introduced." However, HMRC's analysis of the tax relief is significantly more positive. They found that in 2017-2018 RDEC generated "between £5.8 billion and £6.5 billion of additional

127. David Connell, "Is the UK's flagship industrial policy a costly failure?", https://www.jbs.cam.ac.uk/wp-content/uploads/2021/05/cbr-report-uk-flagship-industrial-policy-2021.pdf (2021).
128. Ibid.
129. Ibid.

R&D expenditure."[130] This is excellent value for money taking into account the £2.4 billion cost of RDEC. By contrast, HMRC estimates the additionality ratio for the R&D Scheme for SMEs is significantly smaller, between every £1 foregone in tax revenue stimulates between £0.75 and £1.28 of R&D expenditure.[131] However, this is not a cost-benefit ratio. To fully understand the benefits, we also have to factor in the effect of R&D credits on new businesses undertaking R&D activity, and the total spillovers in terms of productivity.

At the 2020 Budget, R&D Expenditure Credit was increased from 12% to 13%, allowing large firms to offset up to 13% of qualifying costs against their Corporation Tax bill at an annual cost rising to £375 million by the end of Parliament. However, the priority in terms of reform should be the scope rather than the headline rate.

There is a growing consensus that HMRC's definition of R&D is out of touch with modern R&D practices. For instance, data is not classed as a consumable so AI startups are unable to claim relief when they purchase access to datasets. Along similar lines, startups are restricted in their ability to claim for cloud compute services, which are essential to modern research projects. Counterintuitively, they would be able to claim the relief if they built the computing and server capacity themselves. Another issue is User Interface or User Experience (UI/UX) work, which cannot always be claimed as an R&D expense, despite a survey from the Coalition for a Digital Economy found that most startups (four-fifths) undertake this type of work and consider it a vital part of their research.[132]

A recent HM Treasury response to a consultation on R&D tax credits stated that "the government agrees there is a strong case to consider

130. HMRC, "Evaluation of the Research and Development Expenditure Credit (RDEC)", https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/934270/Evaluation_report_-_R_D_RDEC.pdf (2020).
131. HMRC, "Evaluation of the Research and Development Tax Relief for Small and Medium-sized Enterprises", https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/935191/HMRC_Research_Report_598_R-and-D_tax_relief_for_SMEs.pdf (2019).
132. Dom Hallas, "Credit where credit's due: Reforming the R&D Tax Credit", https://coadec.com/news/credit-where-credits-due-reforming-the-rd-tax-credit/ (2019).

bringing data and cloud costs into the scope of the reliefs."[133] At the 2021 Autumn Budget, Chancellor Rishi Sunak announced that the scope of qualifying expenditures to include cloud computing and data costs.[134]

**Recommendation fourteen: In order to ensure value for public money, HM Treasury should adopt the German model for scrutinising tax reliefs.**

In this report, we have picked out a range of economically significant tax expenditures and suggested reforms. However, also in need of reform is our general strategy around tax relief

We use them more than most nations, yet our approach to evaluation is far from systematic. One option, as suggested by Michael Johnson in a previous Bright Blue report, would be to subject all tax reliefs to a five-year sunset clause.[135] However, there is a risk that policy uncertainty reduces the incentive to invest for long-term projects, particularly in the case of structural reliefs such as capital allowances.

By contrast, Germany places a more modest, but still significant, legal obligation on government to report on tax reliefs to parliament every two years. Importantly, the reports must follow a standard evaluative framework, which covers: target-accuracy; cost-effectiveness; necessity; and, sustainability.

133. HM Treasury, "The scope of qualifying expenditures for R&D Tax Credits: 2020 consultation – summary of responses", https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/965087/The_scope_of_qualifying_expenditures_for_R_D_Tax_Credits_summary_of_responses_consultation_.pdf (2021).
134. HM Treasury, "Autumn budget and spending review: 2021", https://www.gov.uk/government/publications/autumn-budget-and-spending-review-2021-documents (2021).
135. Michael Johnson, "Tackling intergenerational inequity at its roots", https://www.brightblue.org.uk/tackling-intergenerational-inequity-at-its-roots/ (2019).

# Chapter 5: **Conclusion**

As living standards are squeezed by the twin pressures of supply chain disruption and high global gas prices, political pressure to address the UK's stagnant productivity growth over the past decade or so is likely to increase. If our productivity problem can be solved it will be solved by the choices Britain's businesses make. As the UK Productivity Institute's Bart van Ark puts it: "Productivity is done by the private sector." Yet, the Government can play an important role in shaping what those decisions will be. Whether or not businesses invest in more energy efficient technologies and whether or not businesses innovate in new fields depends on the structure of the tax system.

This report proposes a fundamental shift in the way we tax businesses to promote investment and growth. Under the status quo, the UK's tax system needlessly discourages investment and entrepreneurship. But, a better tax system is possible. A system that rewards investment and risk-taking, while raising revenue from economic rent. This report shows what that system might look like.

Replacing Corporation Tax with a Business Cashflow Tax, where capital investments are expensed immediately, losses are carried forward with an interest factor, and the bias in favour of debt-financed investments is removed, would be a powerful pro-growth policy. It would extend the logic of the Chancellor's super-deduction in a sustainable way.

Transforming Business Rates into a Business Land Tax, levied on the value of unimproved land rather than property, would eliminate

a major bias against investment and support businesses to make the shift to Net Zero. There is widespread agreement that the status quo is not working, but most alternatives proposed have been ad-hoc. In essence, more reliefs and more complexity. Moving to a Business Land Tax would solve persistent problems without leaving a £25billion hole in the public finances.

The proliferation of business tax reliefs in recent years deserves greater scrutiny. While many reliefs are valuable and stimulate investment in new startups or R&D, some have weak rationales and support could be better targeted elsewhere. A new strategy to apply scrutiny is necessary to ensure reliefs are well-targeted and do not make the tax system unnecessarily complicated.

While this report proposes radical reform, a 'Big Bang' is not necessary. A long-term strategy to enhance capital allowances, provide business rates relief for improvements, and apply greater scrutiny to tax reliefs would be welcome.

To tackle the UK's sluggish productivity levels and persistent under-investment will require us to get serious about reforming the way businesses are taxed. The policies set out in this report show that it is possible to strengthen the incentive to invest without weakening the public finances or reducing the progressivity of the tax system.

If the UK's productivity problem can be solved it will be solved by the choices Britain's businesses make. Yet, government can play an important role in shaping what those decisions will be.

Currently, the UK's business tax system needlessly discourages investment and entrepreneurship. A better tax system is possible. This report shows what that system might look like, proposing reforms to Corporation Tax, Business Rates and business tax reliefs.

Bright Blue Campaign
brightblue.org.uk

ISBN: 978-1-911128-54-0

bright blue