Investing in the UK's future:

The case for fundamental reforms to capital allowances

BT Group

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1 Executive Summary

The UK faces a serious and urgent need to raise its growth rate. Even before the Covid-19 pandemic, the economy had suffered its worst decade for productivity growth since the 1930s. Its record since the financial crisis has been particularly weak. For a while, this was masked by an exceptional performance in growing the labour force. But the era of abundant labour is over, and so the need to find other ways of boosting economic output has become critically important.

Weak business investment explains much of the growth problem, and accounts for up to half of the shortfall against the previous trend since the financial crisis.[1] As Rishi Sunak correctly diagnosed during his time as Chancellor, the challenges businesses face in making investments not only drags down productivity but impedes the technological modernisation that the government has at the heart of its economic vision. Investment in digital infrastructure is the clearest example of the sort that can transform the economy, supporting existing activities but also driving the creation of whole new industries. Another is the infrastructure investment needed to enable the decarbonisation required for Net Zero, estimated at £40 billion a year in 2020.[2]

There is no silver bullet to boost the UK's sluggish business investment. A holistic approach is needed, as well as a continuation of the economic stability established by the current government. But having a competitive tax regime is essential. Reports from the OECD, HM Treasury and centres of expertise like the Oxford University Centre for Business Taxation find a strong relationship between corporate tax rates or capital allowances and firm's investment behaviour.[3]

The impending rise in corporate taxes, alongside the expiry of the corporation tax Super Deduction this March, has created a burning platform. The Chancellor Jeremy Hunt said in his recent Bloomberg speech that "our ambition should be to have nothing less than the most competitive tax regime of any major country".[4] Yet on current plans the UK's corporate tax regime will shortly become one of the least competitive in the OECD. Its headline rate will rise from 19% to 25%, taking it from the joint ninth lowest to the joint ninth highest headline corporate tax rate of 38 OECD countries.[5] Within just two years, the corporation tax take as a share of GDP is forecast to hit its highest level on record.

[1] See e.g. Silvana Tenreyro, "The fall in productivity growth: causes and implications" January 2018 https://www.bankofengland.co.uk/-/media/boe/files/speech/2018/the-fall-in-productivity-growth-causes-and-implications.pdf

[2] PwC "Unlocking capital for Net Zero infrastructure" November 2020 https://www.pwc.co.uk/assets/document/Unlocking-capital-for-net-zero-PwC-Nov-2020.pdf. Estimates are probably higher now, with higher than expected inflation.

[3] There are hundreds of papers. For a sample:
OU Centre for Business Taxation, "The impact of investment incentives: evidence from UK corporation tax returns" January 2016 https://oxfordtax.sbs.ox.ac.uk/files/wp16-01pdf
OECD, "Do Corporate Taxes Reduce Productivity and Investment at the Firm Level?" September 2008 https://read.oecd-ilibrary.org/economics/do-corporate-taxes-reduce-productivity-and-investment-at-the-firm-level_236246774048#page2
E Zwick and J Mahon, American Economic Review, "Tax Policy and Heterogeneous Investment Behavior" January 2017 https://www.aeaweb.org/articles?id=10.1257/aer.20140855
HM Treasury, "Analysis of the dynamic effects of Corporation Tax reductions" December 2013 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/263560/4069_CT_Dynamic_effects_paper_20130312_IW_v2.pdf

[4] Jeremy Hunt, 'Speech at Bloomberg' 27 January 2023 https://www.gov.uk/government/speeches/chancellor-jeremy-hunts-speech-at-bloomberg

[5] OECD, corporate tax statistics, 2022 https://stats.oecd.org/Index.aspx?DataSetCode=TABLE_II1

Furthermore - as the Prime Minister himself highlighted when still Chancellor - the UK has long been a distant outlier when it comes to the generosity of its tax system towards capital investment.[6] While the introduction of the Super Deduction temporarily made the UK's system of capital allowances the most competitive in the OECD, once that expires in April the UK will fall to 33rd out of 38 OECD countries in the league table of capital allowance generosity.[7]

What is needed is an ambitious plan that reflects and changes how companies actually make investment decisions, harnessing businesses' animal spirits and reflecting the real constraints they operate under.

The best option is to introduce a much more competitive system of capital allowances. Ideally, that means full expensing of capital investment in plant and machinery so that companies can write off expenditure in the year it is incurred – a reform that has been explored by a variety of think tanks and has been called for by the CBI, among others.[8] More generous allowances affect investment incentives directly, both through an improved after-tax return and immediate cashflow benefits. Full expensing has the advantage of simplicity – no complicated schedules and asset pools – which is an essential feature of any reform that needs a robust business response.

At an estimated peak annual cost of £11 billion a year[9], full expensing would represent a major investment in the future of British business. It would provide the kind of jolt that the UK economy needs, and keep the UK at the top of the international rankings for the generosity of its capital allowances for machinery. That peak cost would fall through time, as capital allowances largely shift the timing of when taxes fall due, thereby having a lesser effect on borrowing as time passes.

Nevertheless, introducing full expensing on a permanent basis might be challenging given the position of the UK's public finances. A more affordable alternative would be to time-limit the scheme for a four year period (to 2026/27), and attach a commitment to decide upon the long-term future of the scheme at least 12 months before it expires. The advantage of this approach would be that:

- It would not adversely impact the Chancellor's ability to meet his fiscal targets, which are on a five year rolling horizon.
- There would be time for the Treasury to evaluate its effectiveness ahead of deciding on a long-term solution.
- Four years would give more businesses the certainty they need to respond to a generous new scheme, more in tune with the investment cycles that businesses operate against.
- The UK would be propelled to the top of international rankings for the competitiveness of its capital allowance regime, at a critical time for unlocking business investment.

Of the alternatives to full expensing, a permanent first year allowance (FYA) set at 75% for main rate assets would be the next best option, with a peak cost substantially below £11 billion but somewhat above

[6] Rishi Sunak, Mais Lecture, 24 February 2022 https://www.gov.uk/government/speeches/chancellor-rishi-sunaks-mais-lecture-2022

[7] For machinery specifically: Tax Foundation, 'Capital cost recovery across the OECD' 26 April 2022 https://taxfoundation.org/capital-allowances-cost-recovery/

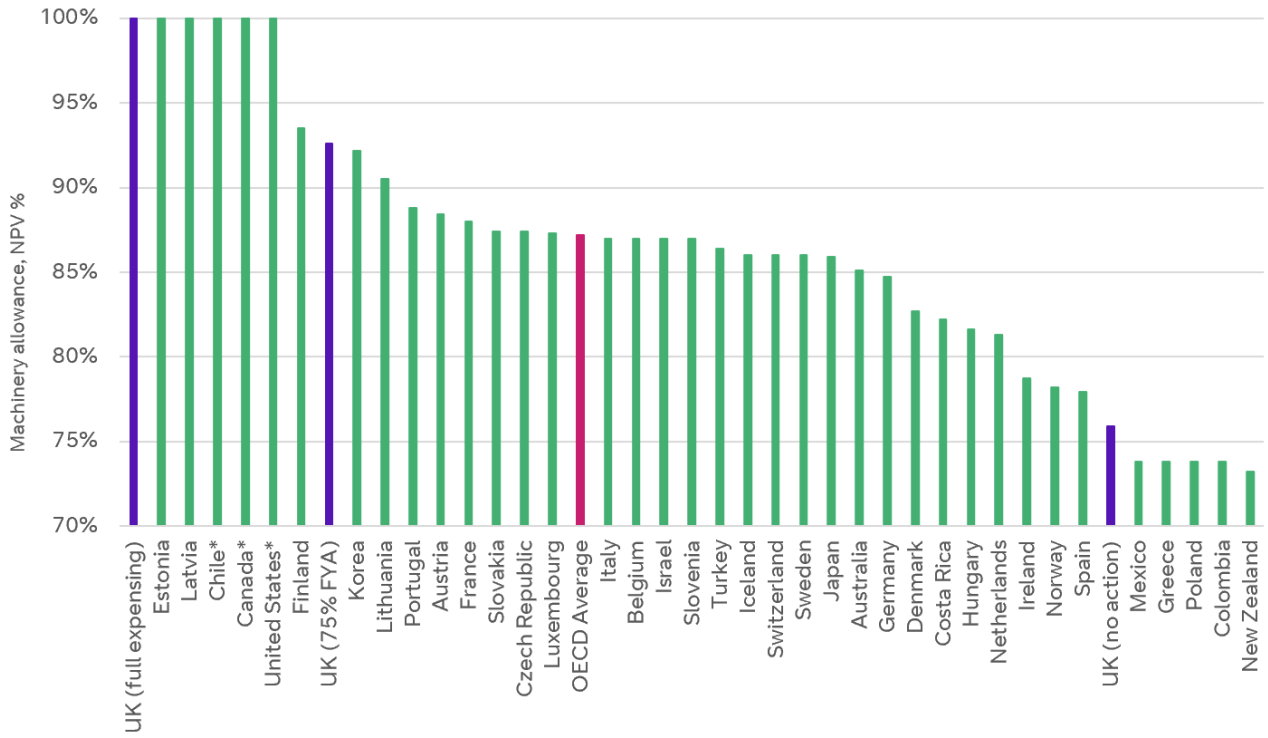
[8] See for example:
Adam Smith Institute, "Abolish the Factory Tax" https://www.adamsmith.org/factory-tax
Centre for Policy Studies, "After the Super Deduction" September 2022 https://www.aei.org/wp-content/uploads/2022/09/Pomerleau_After-the-Super-Deduction-Assessing-Proposals-for-the-Reform-of-Capital-Allowances.pdf
CBI, "A super deduction successor could trigger £40bn-a-year boost for UK business investment" February 2022 https://www.cbi.org.uk/media-centre/articles/a-super-deduction-successor-could-trigger-40bn-a-year-boost-for-uk-business-investment/

[9] HM Government, 'Spring Statement 2022 document' 23 March 2022 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1062708/Spring_Statement_2022_Print.pdf

£3 billion.[10] This option would achieve most of the incentive effects of full expensing and significantly boost the overall competitiveness of the corporate tax regime with the third most generous tax incentive for machinery investment of 38 OECD countries.[11]

But full expensing would have the most powerful impact. The UK has a huge amount of unexploited potential, and a clear and compelling pro-investment tax regime is essential to drive the business investment needed to unlock that potential. As illustrated by Chart 1, by creating and committing to having the best tax regime for investment in the developed world, the UK can present a powerful, optimistic vision for the years ahead.

Chart 1: Net Present Value (NPV) of machinery capital allowances in OECD countries



Source: Tax Foundation, 'Capital Cost Recovery across the OECD'; Author's calculations

[10] £3 billion is the estimate for a 40%/13% first year allowance. HM Government, 'Spring Statement 2022 document' 23 March 2022 https://www.gov.uk/government/publications/spring-statement-2022-documents/spring-statement-2022-html

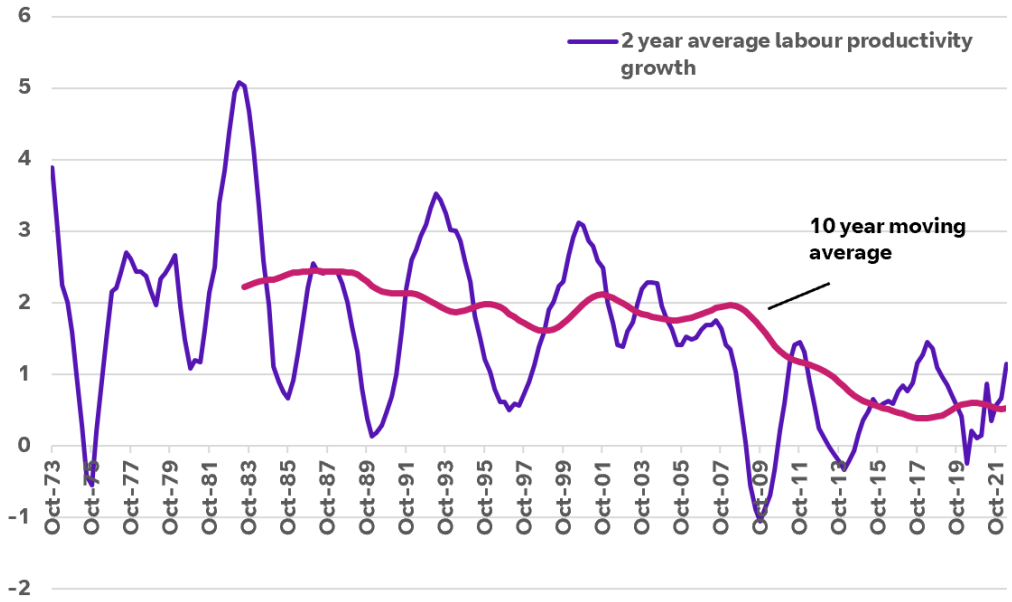
[11] Calculations based on the methodology developed by the Tax Foundation. For underlying assumptions, see: Tax Foundation, 'Capital cost recovery across the OECD' 26 April 2022 https://taxfoundation.org/capital-allowances-cost-recovery/. The United States, Chile and Canada currently offer full expensing on a temporary basis with their schemes all due to begin being wound down within the next two years.

2 The need for business investment: analysing the UK economy's growth and productivity challenge

- The 2010s were the worst decade for UK productivity growth in the post-war era, and without a recovery the 2020s could be worse.
- Looking internationally, the UK's productivity performance was middle-of-the-pack until the financial crisis, but has slipped since then.
- This relatively poor productivity performance was initially balanced by a rising labour force, but the era of abundant labour appears over.
- The UK must therefore find ways of restoring growth through more investment. With public capital spending at its highest sustained level since the 1970s, the focus must be on private sector investment, which has persistently failed to recover to pre-financial crisis levels.
- A failure to deliver an increase in business investment would make an already challenging fiscal situation even worse.

The UK economy is suffering from a prolonged drop in its growth and productivity rates. This is part of a long-term trend that has seen both decline gradually since the 1970s, with the period after the financial crisis in 2008 marking a particularly acute fall. The 2010s were the worst decade for productivity growth since the UK began collecting statistics on the topic; the 2020s, at the current rate, are set to be even worse.

Chart 2: Labour productivity growth, output per hour (%)

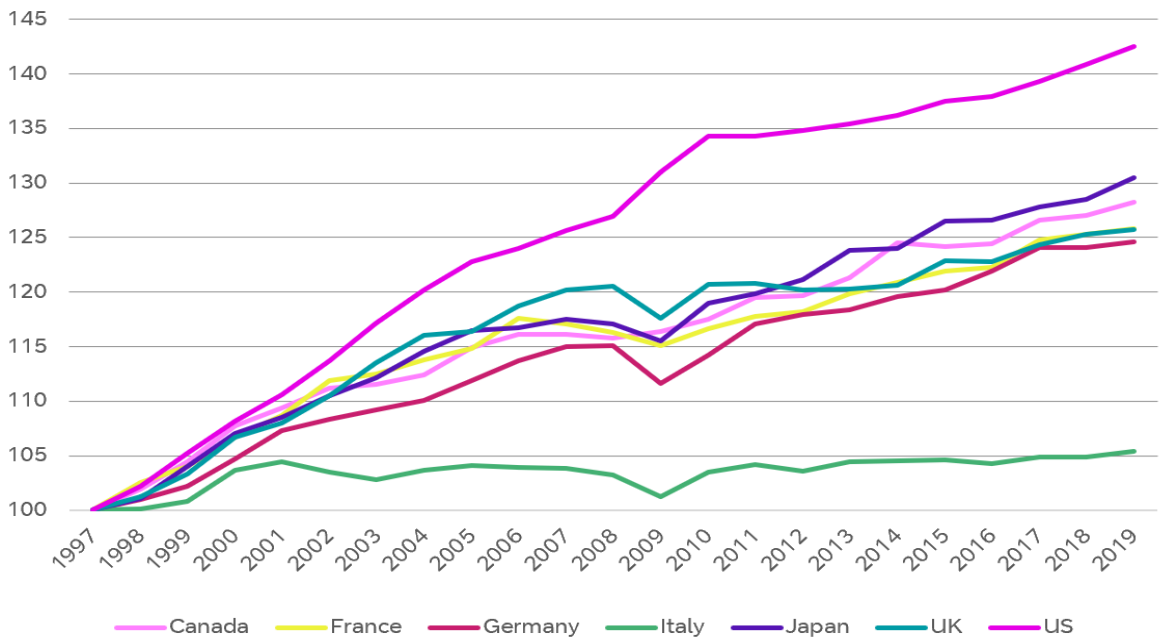


Source: ONS statistics, PRDY dataset

Since 1997 the UK's performance is in the middle of a pack compared to its G7 peers. Hourly productivity figures vary in method, but most estimates put the UK above Japan, Canada and Italy, but well behind

Germany, France and the USA. In terms of trends, at first glance the UK's performance is again middle of the road. In the past 25 years, it has fallen behind the USA by 15-20%, but this is similar to many of its peers.

Chart 3: Hourly output growth, G7 countries, 1997 = 100



Source: Office for National Statistics, "International comparisons of UK productivity"

But the UK stands out for its stagnation since the financial crisis, with only Italy having performed worse. To some extent, the UK has managed to maintain acceptable levels of overall growth through its impressively growing labour force, which since the 1990s has persistently outperformed most of its peers. However, there are limits to how much the country can prosper by drawing on ever more workers. These are limits which the UK has started to hit in the past year, as labour markets have tightened across the world and the UK has faced specific challenges in returning its workforce to pre-Covid levels. The next few years are unlikely to provide the boost of an increasing workforce that the 2010s did, with the UK likely to see a natural decline in its labour pool as the reduced birth rate cohorts enter the workforce.[12]

2.1 Major causes of the fall in productivity

Conventional growth analysis breaks down the economy's performance into three key factors – the amount of labour (workers, and hours worked); the volume of capital that they have to work with (buildings, machinery and other physical structures, as well as intangible items like intellectual property); and the efficiency with which all these factors are brought together, which is usually referred to as total factor or multi-factor productivity.

As mentioned above, the UK's performance in attracting workers into its labour force has been good - although the trends since the end of Covid restrictions have been more worrying.

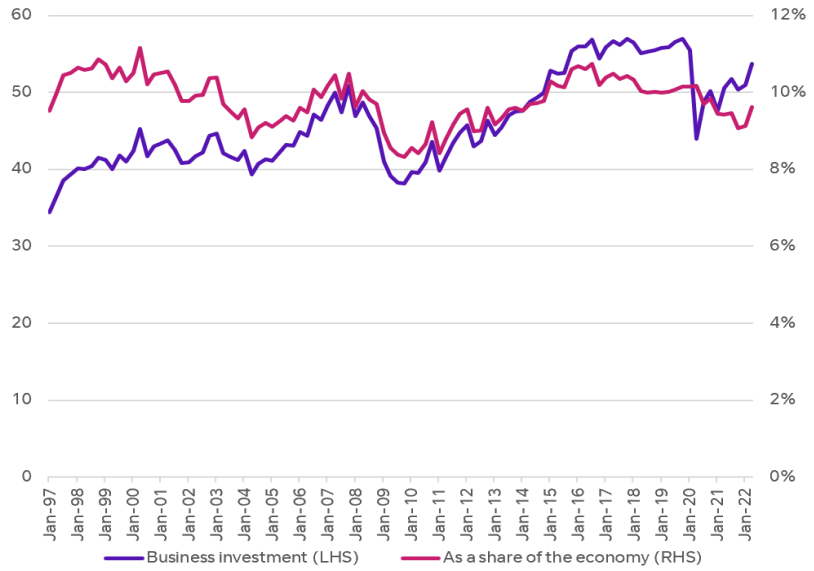
The UK's challenges lie elsewhere. The Office for National Statistics (ONS) has analysed the shortfall in productivity per hour and found that a quarter can be explained by insufficient capital investment, with the

[12] R Riley, "Why are the Over-50s Leaving the Workforce? – Labour Market Flows and Future Participation Flows" 23 January 2023 https://blog.bham.ac.uk/cityredi/why-are-the-over-50s-leaving-the-workforce-labour-market-flows-and-future-participation-flows/

rest put down to multi-factor productivity. Other estimates are higher. Silvana Tenreyro, a member of the Bank of England's Monetary Policy Committee, suggests weak investment has played a significant role in explaining the post-financial crisis slowdown, blaming it for around a half of the shortfall in productivity growth compared to the prior trend.[13] She has isolated the key sectors as manufacturing and finance, with a lesser role played by information and communications, and professional services.

This period of weak capital investment has coincided with fiscal retrenchment. However, it is not reductions in government spending that have been the main driver – in the past decade, forecast and realised government capital spending has risen to levels not seen on a sustained basis since the 1970s. Instead, the major driver behind low overall investment is a weaker contribution from the private sector. For 25 years, business investment has failed to grow significantly as a share of the economy – even failing to respond to the 15 year expansion in GDP that began in 1992.

Chart 4: Business investment in real terms (£bn), and as a share of the economy (%)



Source: Office for National Statistics

2.2 The importance of capital investment

As we discuss below, investment is pursued by businesses seeking an adequate return. However, its role extends beyond the generation of profits. Investment by business boosts the nation's overall capital stock, which is an essential ingredient in the mixture that enables the whole economy to grow more. This is in part because business investment generates valuable positive *spillovers* – that is, benefits that accrue beyond the party engaging directly in the investment. For example, research and development generates innovations that benefit a company, but might also improve workers' skills, consumer outcomes and push forward the frontier of knowledge more generally.[14] This last feature highlights how capital investment has

[13] Silvana Tenreyro, "The fall in productivity growth: causes and implications" January 2018 https://www.bankofengland.co.uk/-/media/boe/files/speech/2018/the-fall-in-productivity-growth-causes-and-implications.pdf. She posits that high levels of uncertainty and the UK's flexible labour market have interacted to shift firms' preferences from capital towards labour.

[14] Department for Business Innovation and Skills (BIS) "The Impact of Investment Assets on Intangible Productivity Spillovers" May 2012 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/32323/12-793-investment-intangible-assets-on-productivity-spillovers.pdf

been vital for economic modernisation, through major transformations such as the laying out of the railway network in the nineteenth century, or nationwide electrification in the twentieth.

Capital does more than just enhance labour productivity in performing the same tasks as before: it is a means through which an economy can transform itself, and start engaging in entirely new activities and processes. This means the returns cannot only be looked at in a static way – in other words, examining the way the economy currently works, and how those activities might be improved – but also dynamically. Investment in general-purpose technologies can improve not just the efficiency and scale of the existing economy, but the very nature of what it does. The best example comes from the exponential advance of computing power, which has seen computers evolve into tiny and ubiquitous devices, with a myriad of uses that were unimaginable when they were room-sized machines.

Digital infrastructure investment captures just as clearly the difference between a static and dynamic view. At a global level, PwC have estimated that 5G will contribute 1.0% of GDP by the end of the decade.[15] Looking more specifically at the UK, this has been analysed at length in a report by Frontier Economics for the National Infrastructure Commission. Full fibre rollout to households generates significant economic benefits to the direct beneficiaries, even if analysis is restricted to examining output of activities already being carried out: virtual and augmented reality, smart home connection, and audio-visual entertainment. In these areas alone, the report conservatively assesses the benefits to reach £17 billion, with another £5 billion in cost savings.[16] Furthermore, research from the CEBR has found that nationwide full fibre rollout could bring one million people back into the workforce.[17] But in a more ambitious scenario, nationwide gigabit-capable broadband access generates use cases for new industries and activities such as tele-health, online learning and a broader range of home entertainment that approximately doubles the economic value of the investment.

2.3 Consequences of a failure to act

Should productivity growth fail to increase materially from the levels we have seen since the financial crisis, there will be significantly negative consequences for the UK economy, living standards, the government's fiscal position and the provision of public services.

As Jeremy Hunt explained last autumn, the government has had to take difficult decisions to stabilise the public finances, in the face of unprecedented headwinds from global inflation, rising interest rates and higher energy costs stemming from the conflict in Ukraine. This includes a sharp rise in the corporation tax rate, a freeze in income tax thresholds, windfall taxes on energy and a challenging spending envelope for resource and capital spending from 2025 onwards. According to forecasts from the Office for Budget Responsibility (OBR), this level of discipline will prove sufficient to leave public sector net debt[18] steady from 2027 onwards, and government net borrowing below 3% of GDP from that year too.

What is less appreciated is that even this tight fiscal situation assumes a benign medium-term economic picture and a return to the levels of productivity and GDP growth that the UK has not achieved consistently

[15] PwC, "The global economic impact of 5G. Powering your tomorrow" 2021 https://www.pwc.com/gx/en/tmt/5g/global-economic-impact-5g.pdf
[16] Frontier Economics, "Future Benefits of Broadband Networks" 12 December https://nic.org.uk/app/uploads/Benefits-analysis.pdf
[17] Openreach, "Ultrafast full fibre broadband: a platform for growth" April 2021 https://www.openreach.com/content/dam/openreach/openreach-dam-files/new-dam-(not-in-use-yet)/documents/reports/Openreach%20Cebr%20Report%202021%20online.pdf
[18] Excluding the Bank of England

in 15 years. The OBR has pencilled in GDP growth in the years 2025 onwards of 2.6%, 2.7% and 2.2%, and productivity growth per worker of around 1.3-1.6% per annum to drive that.

If the next few years repeat the underperformance in productivity that we have seen since the financial crisis, the consequences will be significantly slower growth, leading to a continued squeeze on living standards as well as a further deterioration in the fiscal position. For every percentage point that productivity and growth fail to re-emerge, gross domestic product will be around £25 billion lower, and the public finances around £10 billion worse off.

Restoring productivity growth is therefore essential. A rebound in business investment is critical to achieving this.

3 The drivers of investment, its constraints and the role of tax: the business point of view

- Companies invest for a complex set of reasons, but fundamentally in order to seek a return that is higher than their cost of financing the investment, and which sufficiently compensates for risk.
- The strength and stability of the overall economy is always a key consideration, but sector and technology trends are often relevant.
- Funding is dependent on the nature of the capital asset and its riskiness, which affects the cost of capital and its availability. No company is entirely unconstrained – there are always competing demands for finance.
- Tax plays a key role in investment decisions. In particular, capital allowances have a strong influence not only on the rate of return but also on the immediate availability of funds.
- There is considerable evidence that tax incentives, delivered via changes in capital allowances, have a powerful effect on business investment.

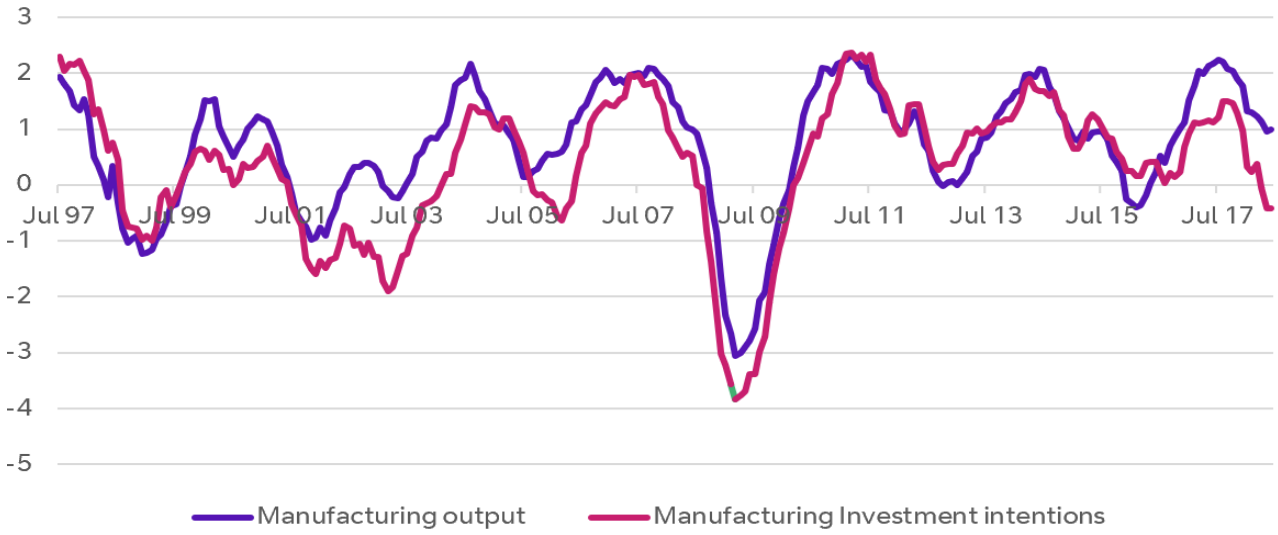
Business investment in the United Kingdom amounts to over £215 billion per year, or around 10% of GDP. In definitional terms, this means spending by businesses on both capital physical assets such as plant, machinery or buildings, and also intellectual products like research and development or patents.

The exact motivation for investment is as varied as business activity itself. A company might invest to cut costs and improve its productivity by acquiring new machinery; for example, a retailer might invest in new inventory management software and automated till equipment. Alternatively, the reason might be to expand operations into a new market, thereby exploiting economies of scale, or to expand a product line through new research and development. Sometimes investment is carried out to replace worn out or outdated assets – a taxi company upgrading its fleet, for example, or a hotel chain refurbishing various sites.

Although this variety might appear to defy generalisation, there are broad constraints and drivers behind business investment. At its core, the business capital acquired must be expected to generate a rate of return sufficient to compensate for the cost of financing it, taking into account all the alternative uses of the funds and the riskiness of the project in question.

On the question of the rate of return, the strength of likely returns is highly affected by the state of the overall economy, which as a result is always strongly correlated with business investment intentions. As well as being observable in macro-economic figures, this can be seen in the correlation between surveys of output expectations and investment intentions, illustrated by Chart 5.

Chart 5: Manufacturing output and investment intentions (-5 to +5 scale)



Source: Bank of England Agent survey

The volatility of returns is also a key consideration. More volatile projects, such as those in start-up companies or new technology ideas, are less easily financeable with debt. Since shareholder equity is more expensive, such projects demand a higher average expected rate of return. Businesses subject to strong regulatory regimes can also buck the sectoral or broader economy trend. Consistent, well-defined regulatory returns provide the kind of certainty that can underpin a longer-term investment plan able to withstand economic and sectoral cycles.

When it comes to the cost and availability of finance, basic economic models portray investment as responding straightforwardly to a simple interest rate. In this portrayal, the central bank can raise business investment simply by lowering that rate, and any project with a higher prospective return will go ahead. However, insofar as there is a "hurdle" rate of return that a project must exceed, companies do not perform a straightforward comparison against the risk-free interest rate. Projects are funded out of a combination of cash on the balance sheet, new equity, debt or combinations of all these. None of these tend to demand a return close to the current base rate.[19] Moreover, all business investments involve some degree of uncertainty. Even those within a reliable regulatory regime may suffer from uncertainty on the cost-side, for example.

The net result is that projects are usually judged against a benchmark hoped-for rate of return much higher than the risk-free rate in the economy; academic studies have found a typical hurdle rate can be closer to 14%, and relatively insensitive to interest rate changes.[20]

Finally, the availability of finance is another key and often under-appreciated consideration. All companies are to some degree financially constrained. In a well-run company, all and any available cash on the

[19] For useful discussions of what motivates business investment, and the role of tax in particular:
Bank of England, "Influences on investment by UK businesses: evidence from the Decision Maker Panel" 2021 https://www.bankofengland.co.uk/quarterly-bulletin/2021/2021-q2/influences-on-investment-by-uk-businesses-evidence-from-the-decision-maker-panel is good.
Also Dumitriu et al, Adam Smith Institute "Abolish the Factory Tax", 2020 https://www.adamsmith.org/research/abolishing-the-factory-tax
HM Treasury, "Analysis of the dynamic effects of Corporation Tax reductions" December 2013
https://www.gov.uk/government/publications/analysis-of-the-dynamic-effects-of-corporation-tax-reductions

[20] Sharpe and Suarez, "Why Isn't Business Investment More Sensitive to Interest Rates? Evidence from Surveys " May 2020
https://pubsonline.informs.org/doi/abs/10.1287/mnsc.2019.3473

balance sheet is subject to multiple claims: from shareholders, from other potential projects, for ongoing operations and working capital, or simply as a buffer to reduce the riskiness of the business.

3.1 The central role of tax in investment decisions

Corporate tax impacts both the return on investment and the cost and availability of funds, depending on the tax measure in question.

A change in the headline corporate tax rate will straightforwardly affect the after-tax return on investment that can accrue to equity holders, and a large enough change will render projects viable or non-viable. A change in capital allowances, however, affects both the returns for a project and the availability of finance for it.

By altering the quantum and timing of write-offs, it can change the taxable profit of a project. Being able to write off the full amount in the first year has a greater value to a company than a schedule of regular write-offs – a consequence of what economists term "the time value of money". The Tax Foundation calculated that the "Super Deduction" – introduced in 2021, which allowed companies to write off 130% of the cost of qualifying projects – raised the net present value of the system of capital allowances from around 45% of the cost to 85%, for example.[21]

This immediacy also means that capital allowances help by improving companies' immediate cash-flow - by lowering the corporate tax bill in the year of the investment - and therefore provide a funding benefit. This can be particularly important in a period of high inflation when companies are facing higher input costs. This is an advantage well known to tax and other financial advisers that specialise in this area but under-appreciated in the broader economic literature.[22] It is an effect most obviously valued by smaller companies that lack ready, cheap and reliable access to external financing, or are reluctant to take on equity. But cashflow is to some degree an important factor in assessing investments at all levels of the corporate world. BT Group, for example, has to weigh the effect of any borrowing for investment on various debt ratios that affect its credit rating.[23] No matter the return on a prospective investment idea, there is not an unlimited supply of risk-finance (debt or equity) available for exploiting it. New borrowing might see interest costs rise significantly on not just a new project, but also for existing operations. Therefore government interventions that provide a cashflow benefit can encourage new investment by effectively helping the business indirectly to finance it in a cheaper and more reliable way.

Tax is also a key consideration for any investment subject to the forces of international competition. Within the same sector or type of asset, there might be a single pool of capital willing to fund new investment, confronting approximately the same underlying economic returns. Although not the sole consideration –

[21] Tax Foundation and Centre for Policy Studies, "After the Super-Deduction - Assessing Proposals for the Reform of Capital Allowances" September 2022 https://www.aei.org/wp-content/uploads/2022/09/Pomerleau_After-the-Super Deduction-Assessing-Proposals-for-the-Reform-of-Capital-Allowances.pdf?x91208

[22] The government itself is interested and understands, however, - asking how capital allowances help, "how they are taken into account, such as by reference to net present values, cash-flow benefits or impacts on effective tax rates":
HM Treasury, "Policy Paper: Potential Reforms to UK's Capital Allowance Regime – Inviting views" May 2022
https://www.gov.uk/government/publications/potential-reforms-to-uks-capital-allowance-regime-inviting-views/potential-reforms-to-uks-capital-allowance-regime-inviting-views
As does the Bank of England: Bank of England, "The Super Deduction creates positive cash-flow effects as businesses can decrease the outflow of cash in tax liabilities in the current period" 2021 https://www.bankofengland.co.uk/quarterly-bulletin/2021/2021-q2/influences-on-investment-by-uk-businesses-evidence-from-the-decision-maker-panel

[23] For an insight into how credit ratings agencies see this, see: "Rating Action commentary, "Fitch Affirms BT Group at 'BBB'; Outlook Stable" October 2022 https://www.fitchratings.com/research/corporate-finance/fitch-affirms-bt-group-at-bbb-outlook-stable-05-10-2022#:~:text=The%20company's%20financial%20profile%20sits,%3A%201.9x%20for%20FY23

political and regulatory stability is always important - the level of tax can easily play the role of tie-breaker in determining where an investor puts their funds.

The significant role played by tax in determining the attractiveness of a proposed investment has led to it being the major tool deployed by governments looking to change the timing, size or nature of private capital deployment in the economy.

This does not mean that taxation is the sole variable determining the level of business investment, or even necessarily the major one; investment is too heterogenous and subject to macro-economic and other hard-to-control influences for this to be the case. But multiple studies have found that corporate tax policy exerts a strong influence. The literature in this area is vast and covers too many periods, jurisdictions and sectors to allow easy generalisation, but there is considerable evidence that real-world outcomes match what would be expected from theory: changes to headline corporate rates and capital allowances regimes that lower effective marginal and average rates tend to boost business investment. The Institute for Fiscal Studies (IFS)[24] has produced a good recent summary of the argument:

> Decisions about whether, where and how much to invest are taken for a wide variety of reasons, many more important than tax. But where a decision is a close call for other reasons, tax can be one factor tipping the balance of competing considerations, and across the economy as a whole that can add up to a significant effect. There is now a large academic literature estimating the effects of corporate taxes on investment and other business decisions. While results of individual studies vary and not all align perfectly with simple theory, overall, surveys and meta-analyses of that literature … reveal overwhelming evidence that higher corporate taxes in general – and headline rates, effective marginal tax rates and effective average tax rates specifically – have substantial effects in terms of reducing investment.

The Bank of England[25] concurs in its discussion of temporary tax incentives like the Super Deduction:

> Previous empirical studies looking at different episodes of temporary tax incentives have found strong effects of capital allowances on investment and evidence in favour of the two channels analysed before. Among others, Zwick and Mahon (2017) and House and Shapiro (2008) studied the effects of the temporary 2003 Bonus Depreciation, reporting high US investment responses, while Maffini et al (2019) found strong impacts on UK investment data due to a permanent increase in the mass of businesses that are eligible for enhanced capital allowances.

[24] Institute for Fiscal Studies (IFS), "Green Budget 2022" October 2022 https://ifs.org.uk/sites/default/files/2022-10/Green-Budget-2022-Corporation-tax-and-investment_0.pdf

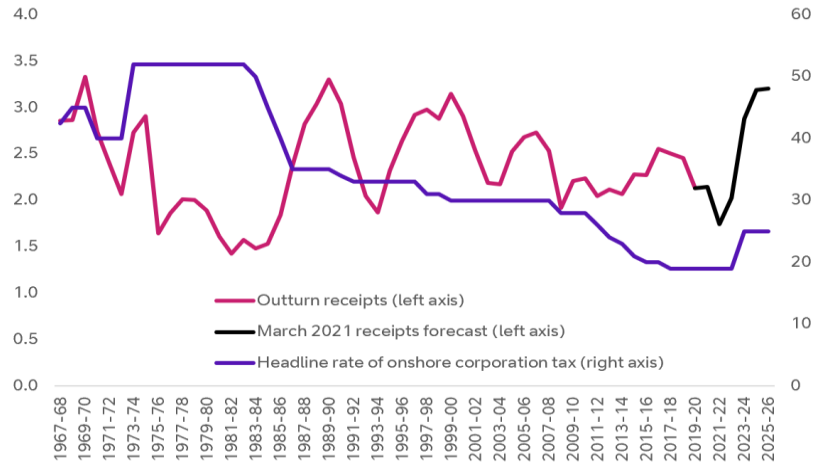
[25] Bank of England, "Influences on investment by UK businesses: evidence from the Decision Maker Panel" 2021 Influences on investment by UK businesses: evidence from the Decision Maker Panel | Bank of England

4 The UK's recent record on corporate taxation and the use of capital allowances

- The UK government's attitude towards corporate taxation has undergone several big shifts, and capital allowances have been managed inconsistently for decades.
- The Super Deduction was brought in as way of boosting the economy in the short term, not as a permanent feature of the tax system. Despite the previous government consulting on permanent changes to the capital allowances system, the long-term model remains unclear.
- Investment did not rebound at an economy-wide level following the introduction of the Super Deduction, but this is easily explained by adverse economic circumstances, not least sharply rising energy prices. The short-term nature of the Super Deduction may also have limited its capacity to generate a stronger effect.
- The simultaneous expiry of the Super Deduction and rise in the corporate tax rate due in the spring of 2023 will herald the sharpest adverse shift in corporate taxation in generations.

Since 1945, the UK's policy towards taxing companies and their investment has undergone a series of revolutions and reversals. Corporation tax – which was introduced at a rate of 42.5% in 1965 as a replacement of an income tax on profits – has risen as high as 52% (from 1973 to 1983), before falling rapidly and then gradually until this year to an all-time low of 19%. In April it will rise to 25%, the sharpest rise in the headline rate since the early 1970s.[26] All else being equal, this will weigh down business investment at exactly the moment the UK economy needs to it be doing more of the heavy lifting to drive economic and productivity growth.

Chart 6: The evolution of onshore corporate tax receipts (£bn) and the headline rate (%)



Source: OBR Economic and Fiscal Outlook March 2021 Chapter 3

[26] See Chart B in: Office for Budgetary Responsibility (OBR), "Economic and fiscal outlook" March 2021 https://obr.uk/efo/economic-and-fiscal-outlook-march-2021/

The history of capital allowances is much more complicated and inconsistent. They were introduced in 1945, with an annual rate of 25% as a replacement for "wear and tear allowances". These in turn had been an approximation of normal depreciation of machinery, first brought in seventy years earlier. There was also a lower 2% rate for industrial buildings and structures, and for a dozen years after 1954 a series of "investment allowances" added on top, which added even further to the overall generosity of the system (these were replaced with direct grants in 1966).

As complexity built up, there were periodic bursts of reform and simplification, cutting the number of rates and the way partially written-down assets were pooled. Political impulses have swung between a target of economic neutrality – which would have allowances match underlying asset depreciation as closely as possible – and a desire to encourage investment in general or in specific types of capital. Assets of different natural lives ideally require different rates, but too many such rates make the system more complicated to administer, so there is a need to balance simplicity with accuracy, too.

Often the direction of travel for capital allowances, in terms of their generosity, has been the opposite to the generally declining headline corporate tax rate (see Table 1). Lower capital allowances raised £2 billion in the first budgets under the Coalition, for example, funding most of the initial cuts in the headline tax rate – echoing a similar switch carried out in the 1980s by the Thatcher governments and Chancellor Nigel Lawson, who wrote of investment reliefs that they "had no economic rationale". Both these periods reflected a desire for greater neutrality in the system, and a belief that focussing on a lower headline tax rate is more appropriate to a modern economy with less emphasis on manufacturing and physical investment, and a greater need for foreign investment. The Labour government of 1997-2010 introduced reforms including an Annual Investment Allowance allowing full write-off up to a low number, intended to favour smaller companies. At the same time, they made the rate on write-down allowances less generous overall in 2007-8 as part of a broad Business Tax Reform package.

The Spring Budget of 2021 marked another epochal change in the UK's corporate taxation framework. Facing a significant fiscal challenge – higher post-Covid public spending demands, alongside higher public debt from pandemic-era spending – the then-chancellor Rishi Sunak set out a plan for a sharply higher marginal corporate tax rate from financial year 2023-24, raising it from 19% to 25%. Alongside this, he announced the Super Deduction, a 130% capital allowance on qualifying investments in plant and machinery, limited to the two years leading up to March 2023. The rate on the Super Deduction was designed to offset the negative effect on investment incentives from the prospective rise in the corporate tax rate.[27] According to Treasury calculations, the Super Deduction would vault the UK from 30th in the OECD to 1st in terms of favourable treatment of capital investment.

Overall, what was announced in March 2021 added up to a powerful inducement to corporate Britain to invest in plant and machinery, after a year in which much activity had stalled thanks to the pandemic. According to calculations from the Tax Foundation, the marginal effective tax rate on investments in plant and machinery would drop from 12.3% to minus 23.2% in 2022, and minus 16.3% the following year.[28] This was a measure to boost an economy held back by Covid, in a pro-investment direction – a demand measure with supply-boosting characteristics as a bonus.

[27] "The Super Deduction more than offsets the negative incentive effects of the pending rate increase for investment in plant and equipment in 2021 and 2022". Bunn and Pomerleau, The Tax Foundation, "Marginal Effective Tax Rates and the 2021 UK Budget" March 2021 https://taxfoundation.org/2021-uk-budget-tax-proposals/

[28] See: Bunn and Pomerleau, The Tax Foundation, "Marginal Effective Tax Rates and the 2021 UK Budget" March 2021 https://taxfoundation.org/2021-uk-budget-tax-proposals/. They assume a 35/65 debt-equity split

Table 1: Phases of UK corporate tax policy

Period	Corporate tax rate	Capital Allowances	Investment outcome and commentary
1965-1980	45-52% - as high as it has ever been	Mostly very generous – well above 'neutrality' in order to encourage investment above what might be natural	Capital investment in the UK was generally high compared to subsequent periods
1980-1997	Steadily cut to 33%	Much less generous, aiming for levels close to the neutral rate that reflects asset depreciation. Funds saved went in part towards lower headline rates	Economy-wide investment was lower than in the previous period, albeit rising sharply in the boom of the late 1980s. This was accompanied by a sharp fall in manufacturing's share of the economy, as well as privatisation
1997-2010	Further, slower falls to 28%	Reforms that lowered the generosity of allowances in general tilted	Business investment and overall levels of investment in the economy remained low, particularly when accounting for the steadily growing macroeconomy
2010-2021	Steady cuts in the main rate from 28% to 19%, set out in advance	Less generosity in the overall capital allowance system, but periodic improvements in the Annual Investment Allowance, aimed at helping smaller companies	A continuation of the theme of lower headline tax rates, with any generosity in the allowance system reserved for smaller companies. This still fails to elicit a strong reaction in terms of higher business investment
2021-2023	A scheduled rise in the main rate back to 25%, starting in 2023	A temporary "super" deduction – the ability to write off 130% of qualifying investment in plant and machinery	A temporary policy designed to encourage investment at a sensitive time for an economy recovering from the pandemic. Its effect was obscured by the economic shock of the Ukraine conflict

4.1 The performance of the Super Deduction

The Super Deduction was the most generous single inducement for investment in a generation. However, it is difficult to assess its impact accurately, given the countervailing economic shocks that occurred subsequently, blunting its effect. A wealth of data demonstrates that business investment is highly responsive to the expected future health of the economy, cost pressures and uncertainty in general. Since the Russian invasion of Ukraine and subsequent surge in inflation, future expectations of the strength of the economy have dropped, and so have investment intentions. Business has also been in the process of adjusting to the new post-Brexit trading relationship with the EU.

Furthermore, it is not possible to know the counterfactual, across the whole economy. In its analysis[29], the OBR argued that the Super Deduction would serve to bring forward capital spending from future periods, motivating managers to invest to seize maximum advantage of the tax and cashflow benefits. The Bank of

[29] OBR, "Supplementary forecast information release" February 2022 https://obr.uk/docs/dlm_uploads/superdeduction_supplementary_release.pdf

England's Decision Makers' Panel survey reinforced this view, finding that the overall effect of the Spring Budget's tax decisions (Super Deduction as well as impending Corporate Tax rate rise) would be to raise investment over the following two years by 6%. Whereas some companies (see BT case study) have a sufficiently stable pipeline of future investment projects for policy changes to be isolated and evaluated, this is much harder to carry out across thousands of companies. It is possible that investment in plant and machinery would have fallen sharply, absent the Super Deduction.

Temporary tax measures are limited, by definition. Business investment takes time to prepare, and the assets produced are often very long-lasting – particularly infrastructure. There are good reasons to believe that permanent changes to the tax system are more likely to have a powerful effect. That said, temporary measures can work if they are timed to hit the economy when it has the capacity to respond. In the run-up to the March 2021 Budget, the Treasury had every reason to think that a two-year investment surge could be absorbed by an economy still recovering from its pandemic pause. It is highly unfortunate that what ensued was instead a period of supply-shortages, soaring energy prices and inflation.[30]

Finally, because it was limited to such a short time period, the Super Deduction was never likely to shift the UK permanently out of its relative low-investment position. As the OBR itself wrote, "As a temporary measure, it will not affect the long-run cost of capital and therefore we did not assume that it would affect the level of investment and the capital stock in the longer term."[31] To do that would require the certainty of an improved capital allowance regime that is expected to last for a longer time period. In the words of the Tax Foundation, "the temporary nature of the 2021 UK budget's expansion of deductions for capital investment and the coming corporate rate hike [made] the UK's situation unique. Both policy changes will erode incentives to invest that might have otherwise been present under a permanent policy".[32]

4.2 Case study: BT Group's investment in full fibre

BT Group is one of the UK's leading investors, with £4.8 billion of annual capital expenditure before spectrum costs.[33] Over half of this is being invested in the upgrade and maintenance of the broadband network, led by BT's independent subsidiary Openreach, which has a target of passing 25 million homes and businesses with gigabit-capable broadband.

In common with many businesses, BT makes investment decisions on the basis of forecast post-tax cashflows. A key part of this is the cashflow funding requirement needed upfront; as an investor in very long-lived assets, the payback period for capital like broadband is protracted, leaving the company with negative cash for a substantial length of time.

The combined effect of the future rise in the headline corporate tax rate to 25% from 19%, plus the immediate creation of a 130% Super Deduction, was to leave the effective after-tax return on investments made by BT in 2021-23 roughly unchanged; the "super" part of the Super Deduction (the extra 30%) roughly counteracted the rise in the headline rate, as designed. However, the ability to claim costs of

[30] Steve Watts of BDO has argued that time-limited ideas "may equally contribute to a cycle of boom and bust in capital investments". Steve Watts in Bloomberg Tax, "UK Capital Allowances After the Super-Deduction: Will Things Ever Be So Good Again?" May 2022 https://news.bloombergtax.com/tax-insights-and-commentary/uk-capital-allowances-after-the-super-deduction-will-things-ever-be-so-good-again

[31] OBR, "Capital allowances super deduction costing", February 2022 https://obr.uk/docs/dlm_uploads/superdeduction_supplementary_release.pdf

[32] D Bunn and K Pomerleau, Tax Foundation "Marginal Effective Tax Rates and the 2021 UK Budget" March 2021 https://taxfoundation.org/2021-uk-budget-tax-proposals/

[33] BT Group, "Group performance 2022 summary" 2022 https://www.bt.com/about/annual-reports/2022summary/assets/documents/Group_performance.pdf

investment immediately against the current year's tax bill generated an immediate financial benefit when the investment is made. Over its five-year planning window, BT expected an improved cashflow as a result of the Super Deduction of around £650 million.

BT's response to this improvement in cashflow was to raise investment in full fibre. Given its need to maintain a good credit rating, the limited pool of international capital aimed at broadband investment in the UK, and BT's already ambitious capital spending plans, its pre-2021 plans were in effect limited by its cashflow.

The Super Deduction freed up cash that enabled BT to raise investment in Openreach, allowing them to pursue a bigger, quicker target for broadband investment. In May 2021, alongside its annual results, BT was able to announce an increase in and acceleration of its installation of gigabit-capable full fibre broadband from 20 million to 25 million households. Openreach's capital expenditure was able to rise by 7% in 2021 compared to 2020, and a further 13% in 2022, to £2,548 million.

One of the reasons why BT could do this is that it has the kind of investment programme that can be scaled up (or down) relatively easily, subject to reasonable supply constraints. Its rollout of full fibre broadband is "modular", so new additions do not have a linear dependence on other parts of the investment scheme. As a result, Openreach was able to increase its capital expenditure by almost 21% in two years.

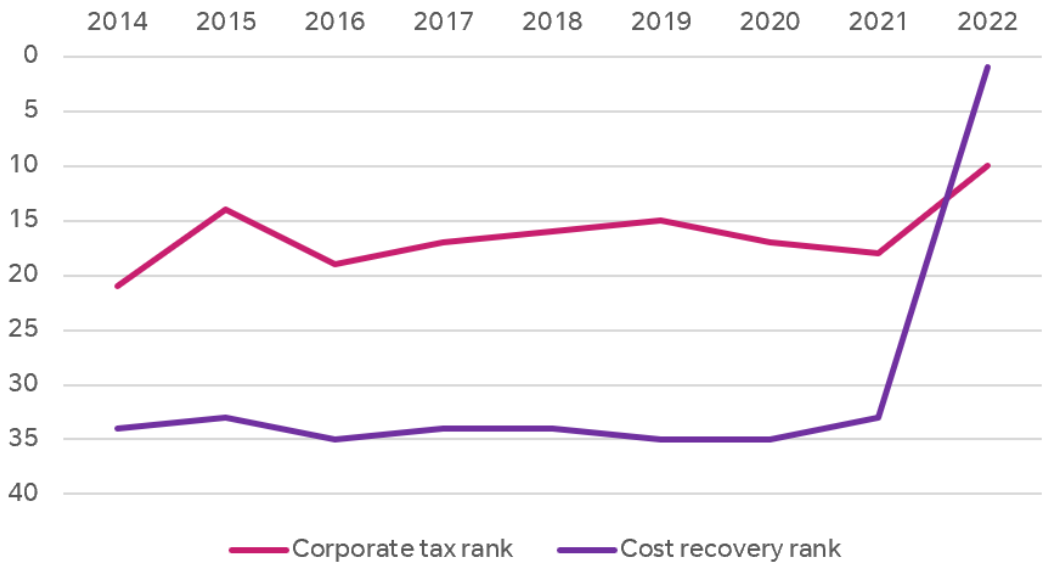
The effect of a hard stop to the Super Deduction - alongside a newly higher corporate tax rate - will clearly serve to add to the rising costs which all businesses are currently facing, as well as limiting the scope to make further investments to improve digital connectivity in future. The spillover benefits of fibre investment, such as bringing people back into the workforce and improving productivity and growth, mean this would have knock on impacts for the wider economy.

4.3 The UK's position internationally

As well as playing a crucial role in companies' decisions to proceed or not with new ventures, a competitive tax regime is key to selling UK plc to overseas investors. In spite of devoting tens of billions in fiscal resources to a lower headline rate, the UK until 2021 was barely treading water in terms of the international competitiveness of its corporate tax system. As Rishi Sunak acknowledged in his Mais Lecture as Chancellor in February 2022, before the Super Deduction, the UK's overall treatment of capital investment lagged far behind that of peer countries. The Super Deduction was the first measure to move it significantly up the rankings.[34]

[34] See Tax Foundation, "International Tax Competitiveness Index 2022" https://files.taxfoundation.org/20221013150933/International-Tax-Competitiveness-Index-2022.pdf?_gl=1*f2c2ei*_ga*Nzk3MTEzODk1LjE2NzExMTgwNzE.*_ga_FP7KWDV08V*MTY3NDEyOTgzOC4xMC4xLjE2NzQxMzE0NDIuNjAuMC4 and previous publications

Chart 7: UK tax competitiveness ranking since 2014



Source: various Tax Foundation reports

In the category of "cost recovery", which largely reflects factors like the capital allowance regime, the Super Deduction allowed the UK to leap from 31st out of 38 OECD countries in the rankings to 1st (on plant and machinery). In 2021, the net present value of the UK's Capital Allowances for plant and machinery stood at around 75.9%, compared to an OECD average of 85.2%.[35]

[35] Tax Foundation, "Capital Cost Recovery across the OECD" March 2021 https://taxfoundation.org/capital-allowances-capital-cost-recovery-2021/#Economic

5 The case for change to a pro-investment capital allowances regime

- Not only does the UK have a long-term problem with its tax system for investment, but a serious cliff-edge looms as the Super Deduction comes to an end and the main rate of corporate taxation rises.
- This will see the UK's corporate tax take increase sharply.
- Unless action is taken, the UK will drop from first to 33rd out of 38 OECD countries when it comes to international tax competitiveness of its incentives to invest in plant and machinery.

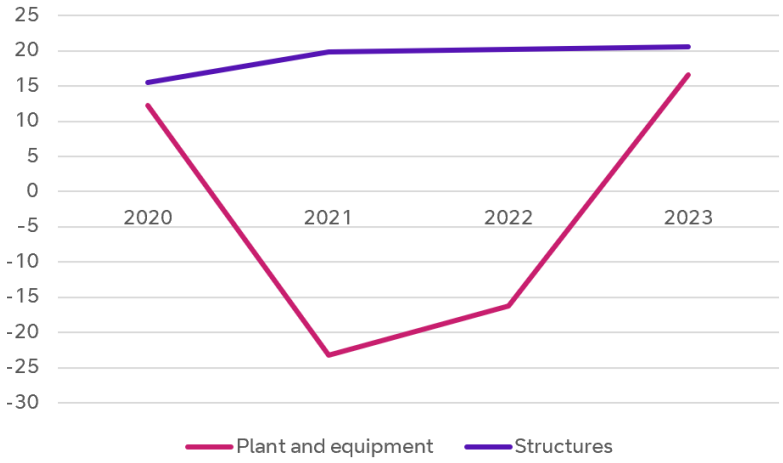
Delivered in February 2022, as Russia began its invasion of Ukraine, Rishi Sunak's Mais Lecture developed further the rationale for the Super Deduction and built the case for a longer-term shift in emphasis. The previous approach had not been working:

> "the overall tax treatment provided for capital investment is much less generous than the OECD average. It is unclear that cutting the headline corporation tax rate did lead to a step change in business investment; we need our future tax policy to be targeted and strategic."

But a year later, the immediate challenge is the avoidance of a cliff edge deterioration in the tax environment for investment. In 2023, the tax system is set to turn in a drastically anti-investment direction, with the expiry of the Super Deduction and sharp increase in headline rate of corporate tax. According to analysis from the Tax Foundation the marginal effective tax rate on plant and machinery was forecast to snap back from minus 16 to plus 16%.[36] If there is no follow-on support to the Super Deduction, the UK will once again collapse towards the bottom of international rankings - potentially as far as 33rd out of 38 OECD countries for the generosity of its incentives to invest in machinery.[37] At the same time, with the headline rate of corporation tax rising from 19% to 25% in April 2023, the UK's corporate tax regime will be significantly less competitive with a headline rate that ranks the UK in the middle of G20 countries (from its current position as the lowest rate in the G20) and the joint ninth highest corporate tax rate of 38 OECD countries.[38]

[36] Tax Foundation, "Capital Cost Recovery across the OECD" April 2022 https://taxfoundation.org/capital-allowances-cost-recovery/
[37] Tax Foundation, "International Tax Competitiveness Index 2021" October 2021 https://taxfoundation.org/2021-international-tax-competitiveness-index/
[38] OECD, corporate tax statistics, 2022 https://stats.oecd.org/Index.aspx?DataSetCode=TABLE_II1

Chart 8: Marginal effective tax rates (%)



Source: Tax Foundation

In the Spring Statement shortly after his Mais Lecture, Rishi Sunak acknowledged the cliff-edge facing the UK. The rise in the headline corporation tax rate to 25% will be the greatest since the 1970s, when the rate rose from 40 to 52%. As a share of GDP, the latest OBR forecasts predict onshore corporation share receipts of £95 billion in 2025/26, which at 3.5% of GDP is the highest amount ever. The only time the UK has come close to such a figure was at the peak of the late 1980s boom. There has certainly never been such a high corporate tax burden during a period of economic weakness.

Conscious of this impending loss of competitiveness, in that same Spring Statement Rishi Sunak promised to address it.[39] In making this commitment, he was effectively plotting a longer term course: a permanent shift to a new regime that might help to fix the problem of chronic low investment in the UK economy, rather than just a short-term fiscal boost. The Treasury subsequently issued a call for evidence on what should come after the Super Deduction, with ideas ranging from tweaks to the existing system of smaller company allowances, to the boldest possible option of full, first year write offs of qualifying investments. The moment to fulfil that commitment is now.

[39] "Capital investment by UK businesses is considerably lower than the OECD average of 14%. And it accounts for fully half our productivity gap with France and Germany. Once the Super Deduction ends next year, our overall tax treatment for capital investment will be far less generous than other advanced economies. ***We're going to fix that***." [Our emphasis] Rishi Sunak, 'Spring Statement' March 2022 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1062708/Spring_Statement_2022_Print.pdf

6 Characteristics of a successful reform

- Any replacement must reflect how businesses actually make investment decisions, must be simple, and focus rigorously on productive investment.
- Full expensing for plant and machinery is the best option for the UK's largest investors. It benefits from simplicity and clear, enduring financial incentives, and would put the UK at the top of international league tables of competitiveness.
- A time-limited trial of full expensing is an affordable alternative – but the period must be long enough to enable businesses to plan.
- If the pressure of affordability renders full expensing too costly, a reasonable alternative is a much higher First Year Allowance (e.g. 75%).
- Further moves on the Annual Investment Allowance will have little effect, as the great bulk of corporate investment is carried out by large companies already investing far more than the £1 million limit.

Published in May 2022, the Treasury's call for evidence[40] sought to understand the impacts that the Super Deduction had on business investment and potential reform options, including the option to introduce full expensing. It emphasised that the government needed a reform that:

- Reflects accurately how businesses actually make decisions, in particular the crucial importance of cashflow.
- Learns from the experience of the Super Deduction.
- Appreciates the importance of simplicity in design.

In addition, and particularly since the difficulties of last autumn, any reform must be affordable for the Exchequer and focus on how overall levels of business investment can be boosted. As part of this, reforms to tax must go with the grain of the government's wider priorities: levelling up, green growth and the pursuit of technological leadership.

6.1 Options under consideration: the case for full expensing

For businesses carrying out large-scale investment in productive UK capital, the most beneficial option from the call for evidence is **full expensing**. This would allow a 100% deduction on main rate plant and machinery investment in the year the expenditure is incurred, rather than having it written off gradually over an extended period. This gives most companies immediate cashflow relief on their investment, as well as improving the rate of return (since cash up front is more valuable than a stream of future payments).

Its benefits are supported by several recent studies. Writing in 2020, economists from the Adam Smith Institute estimated that full expensing might boost investment in the relevant assets by 8%. More recent work by the Centre for Policy Studies and American Enterprise Institute estimates that total investment

[40] HM Treasury, "Policy Paper: Potential Reforms to UK's Capital Allowance Regime – Inviting views" May 2022 https://www.gov.uk/government/publications/potential-reforms-to-uks-capital-allowance-regime-inviting-views/potential-reforms-to-uks-capital-allowance-regime-inviting-views

would rise by 4.2%, and GDP by 2.5%.[41] The Tax Foundation models the effect as raising the long term capital stock of the US economy by 13%.[42]

Full expensing offers the greatest financial incentive for businesses to increase overall investment levels – both in terms of its impact on expected rate of return and also cashflow. Its simplicity is a further advantage. Reforms that are straightforward for businesses and investors enhance take-up and also cut administrative costs for claimants and tax authorities. As illustrated by Chart 1, its introduction would guarantee the UK has the most generous business investment incentives among advanced economies.[43]

However, it is also the most expensive option, with the Treasury estimating that it would cost £11 billion at its peak, albeit falling quickly from there. If current pressures on the public finances force a more cautious approach upon the government, there are good alternatives. Top of the list should be **full expensing for plant and machinery to the end of the 2026/27 tax year**. This option provides enough certainty for business, which often operates to a multi-year investment cycle. One of the potential learnings from the Super Deduction failing to produce the projected results may be that that many businesses struggled to scale up investment in time, and the two-year horizon contained too much short-term volatility. A four-year trial of full expensing will also provide the Treasury with evidence sufficient to carry out an in-depth review of its effectiveness, informing any further decision about its continuation beyond 2026/27. It is a far more appropriate timescale for the kinds of committed, long-term investments that will be needed for net zero, such as grid infrastructure. Ideally, in the interest of business certainty, such a review should be carried out with enough time for any follow-up to be announced with at least 12 months to go before the end of the 2026/27 tax year, and consider whether full expensing has been more effective at incentivising investment in specific asset classes like digital infrastructure or to support critical policy objectives (e.g. delivery of net zero).

6.2 Other alternatives to full expensing

Several alternatives to full expensing have been put forward by the Treasury and other stakeholders. If any kind of full expensing is judged prohibitively expensive, the next best alternative would be **permanent first year allowances set at 75% for main rate plant and machinery assets**. First year allowances at this level will achieve most of the incentive effects of full expensing at a lower cost to the Exchequer (well below the £11 billion peak cost of full expensing, but above the £3 billion peak cost the Treasury estimates for a 40%/13% first year allowance).[44] It will still significantly boost the overall competitiveness of the corporate tax regime. Analysis suggests these rates would produce allowances with a net present value of 92.6% - better than any other large advanced economy in the generosity of its incentives for plant and machinery. It would lag only Estonia and Latvia, which offer full expensing on a permanent basis, assuming the United States, Chile and Canada wind down their temporary full expensing schemes over the next two years.[45]

[41] Centre for Policy Studies, "After the Super Deduction" September 2022 https://www.aei.org/wp-content/uploads/2022/09/Pomerleau_After-the-Super-Deduction-Assessing-Proposals-for-the-Reform-of-Capital-Allowances.pdf

[42] Tax Foundation, "Reviewing the economic and revenue implications of cost recovery options" April 2020 https://taxfoundation.org/full-immediate-expensing/

[43] HM Treasury "Spring Statement" March 2022 https://www.gov.uk/government/publications/spring-statement-2022-documents/spring-statement-2022-html

[44] HM Treasury "Spring Statement" March 2022 https://www.gov.uk/government/publications/spring-statement-2022-documents/spring-statement-2022-html

[45] Calculations based on the methodology developed by the Tax Foundation. For underlying assumptions, see: Tax Foundation, "Capital Cost Recovery across the OECD" April 2022 https://taxfoundation.org/capital-allowances-cost-recovery/

Raising the headline rates of writing down allowances – for example, from the current 18% for main rate assets and 6% for special rate assets to 25% and 10% – might be achieved in a way that leaves the cost to the Exchequer at a similar level to the first year allowances mentioned above. The Treasury has estimated that raising write-down rates to 20% and 8% would cost £2 billion a year at its peak.[46] While the overall impact on the expected rate of return may be similar for both options, first year allowances offer businesses an immediate cashflow benefit from the point they come into force. Therefore, on balance, more generous first year allowances are preferred to higher writing down allowances.

Further changes to **raise the value of the Annual Investment Allowance (AIA)**. The decision to permanently increase the AIA to £1 million, confirmed at last year's Autumn Statement, is welcome. However, at this level the Treasury has already confirmed that it now covers the investment needs of 99% of UK businesses. Further increases – though expensive – are of limited benefit to the types of companies making large-scale investments in UK infrastructure, particularly those responsible for individual projects worth billions in areas like transport, digital networks and trade infrastructure that are major growth enablers for businesses of all sizes across the country. According to the IFS, just £23 billion of investment was carried out under the AIA in 2019-20, which equates to significantly less than a third of the total amount invested in plant and machinery that year.[47] [48] The concentration of investment by the largest companies can also be seen in the distribution of capital allowances where just 0.18% of companies that benefited from capital allowances in 2020/21 (1,806 companies out of a total 1,020,003) claimed capital allowances above £5 million, but accounted for 63% of the £94.6 billion claimed that year.[49]

There is therefore a compelling case for keeping the AIA at its current level and using any available funding to deliver one of the other options highlighted above.

[46] HM Treasury "Spring Statement" March 2022 https://www.gov.uk/government/publications/spring-statement-2022-documents/spring-statement-2022-html

[47] IFS "Green Budget 2022" October 2022 https://ifs.org.uk/sites/default/files/2022-10/Green-Budget-2022-Corporation-tax-and-investment_0.pdf

[48] Figures for total plant and machinery from ONS, summing Transport equipment, ICT and other machinery to approximately £84 billion https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/edwh/cxnv

[49] See figures from table 12A and 12B: HM Revenue and Customs (HMRC) "Corporation Tax Statistics 2022", September 2022 https://www.gov.uk/government/statistics/corporation-tax-statistics-2022

22 February 2023

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