Budget 2021: A Recipe for Recovery?

by Tom Clougherty

Summary

- The Chancellor's most urgent priority at the Budget is to support the economy through the final stages of the pandemic
- That means extending furlough, the business rates holiday, welfare support and the stamp duty holiday, and ideally making the last of these permanent. It also means delaying the planned increase in the scope and level of the National Living Wage, in order to prioritise youth employment
- Beyond that, the best long-term recipe for prosperity is to prioritise growth over immediate deficit reduction
- While any tax rises would be a mistake, tax rises on the businesses that will drive recovery would be a greater error – as would using the Budget to signal a long-term trajectory of higher business taxation
- Many of the proposals reportedly being considered by the Treasury would dampen recovery, harm Britain's tax competitiveness and encourage international investment to go elsewhere
- We outline instead a robust pro-growth agenda, including bounties for firms to create new jobs; business rates reform; and the introduction of 'full expensing'
- We urge the Chancellor to commit to Britain having the most competitive tax system in the G20 by the end of the parliament, in order to give firms and investors confidence and drive growth and recovery

Introduction

This is not be the Budget that Rishi Sunak wanted to deliver. By now, the Chancellor would have hoped that the pandemic would be behind us, and the economic support measures he introduced largely unwound. This would have been the moment at which he laid out his own vision of Britain's economic future, and started to implement the reforms that he believes in.

As it turns out, however, the Chancellor's main task on Budget day will be to address the continuing demands of the pandemic, setting out how the Government will continue to support for business and the wider economy until we're ready to truly move on.

Yet the Chancellor can at least set a direction for the future, and give business, investors and voters an idea of the kind of peacetime Chancellor he intends to be.

Perhaps the most important guideline for Rishi Sunak to follow is that old medical principle: 'First, do no harm.' Concern for the state of the public finances is an admirable quality in any Chancellor. But there is a strong consensus among economists that it would be actively counter-productive to prioritise deficit reduction now. Our total debt interest costs are low as a percentage of GDP (half the level they were in the early 1980s). We can borrow very cheaply at very long maturities, which means those low costs are locked in for years (or even decades) to come. And as long as our rate of economic growth exceeds the interest rate on our borrowing, the pandemic debt will dwindle away over time.[1]

So the focus of any agenda the Chancellor lays out should be economic growth. That means promoting enterprise, supporting investment and making sure that Britain maintains and then enhances its economic competitiveness.

The CPS has already set out a range of proposals along these lines, ranging from our joint paper with the Rt Hon Sajid Javid MP, 'After the Virus', to more recent proposals alongside the Northern Research Group of Conservative MPs to reinvigorate the North.[2] We also recently examined the history of the postwar era and showed that those countries that did best were those where it was the market that drove recovery rather than the state.[3]

In this pre-Budget briefing paper, we will focus specifically on the tax system and fiscal policy, and ask how the Chancellor can deliver a robust agenda for growth driven by private enterprise and investment.

Immediate Priorities

As we set out in our paper 'History Repeating?', the lesson of the postwar years is that wartime interventions are best dismantled quickly, with the economy not just permitted but encouraged to adjust to a new state of affairs.

That lesson, however, obviously does not apply while the Government is still imposing restrictions that dampen much economic activity and outright forbid even more. The various support schemes the Government has introduced are hugely expensive – but shutting off the medicine when the patient is so close to recovery would be even more so in the long run.

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[1] Whether the total debt burden rises, falls, or stabilises over will depend on the extent of future borrowing, the interest rate on new debt, and the strength of future economic growth. For more on this issue, see Pedro Serôdio, 'How I learned to stop worrying and love the debt,' *Works in Progress* 3 (February 2021).

[2] Sajid Javid MP and Centre for Policy Studies, 'After the Virus: A plan for restoring growth' (June 2020); Jake Berry MP and Nick King, 'A Northern Big Bang: Unleashing Investment in the North,' Centre for Policy Studies (February 2021).

[3] Jethro Elsden, 'History Repeating? The lessons of the postwar recovery,' Centre for Policy Studies (February 2021).

Employment

The numbers on the furlough scheme have fallen from last year's highs, but it is still supporting roughly five million people.[4] If support is withdrawn before the economy can properly reopen, jobs are likely to be lost unnecessarily. Given the likely progress of the vaccination schedule, it would make sense to **extend the full furlough scheme for at least another three months**, and then to **gradually taper the generosity of the scheme over another three months** (as occurred last year).

Before long, though, the Chancellor will want policy to encourage businesses to bring people back from furlough, and indeed to create new jobs where viable. The Government could accomplish this through a broader and more generous system of employment allowances applied to employers' National Insurance contributions. **Employers could receive a £2,000 allowance for every additional full-time equivalent position created**. The Chancellor could also consider introducing something like the cancelled Job Retention Bonus, to encourage employers to bring staff back from furlough and keep them employed. Such measures should apply for the whole of the 2021/22 tax year.

If boosting employment is the goal, then there's another issue the Chancellor should consider: the planned increases in the minimum wage. Employment data shows that it is young people who have taken the brunt of job losses during the pandemic. And CPS research has shown that raising the National Living Wage to two-thirds of median earnings and extending it below the age of 25 could potentially cost hundreds of thousands of jobs.[5] The worst affected sectors would be hospitality, retail, and social care; the worst affected demographic would be young people. In other words, precisely the industries and workers that have suffered economically during the pandemic. In order to promote employment, the Chancellor should **press pause on plans to extend the National Living Wage**.

Business rates

The Chancellor is reportedly considering **an extension of the business rates holiday**. We believe that this should be done for another year, to avoid suddenly burdening companies with large bills before the economy recovers. However, we also suggest a change in the way it operates. As things stand, relief is targeted at specific sectors. Going forward, it might make more sense to make **business rate relief more widely available but limit it to businesses that can demonstrate a significant loss of revenue/fall in profit during the pandemic**. (This could, if feasible, be done on a sliding scale based on how bad that shortfall had been in 2020/21.)

Looking further ahead to the fundamental review of business rates promised in the autumn, there is certainly a case for a comprehensive overhaul. As things stand, business rates can be a significant impediment to productivity-enhancing investment in a firm's premises, since 'rateable value' includes not just the value of the commercial site, but also the structures and buildings on it, as well as a range of infrastructure, plant, and machinery.[6]

[4] HM Revenue & Customs, 'Coronavirus Job Retention Scheme statistics: February 2021.'

[5] Jethro Elsden, 'The Case Against Raising the Minimum Wage,' Centre for Policy Studies (November 2020).

[6] For a full examination of this issue, see Adam Corlett et al., 'Replacing business rates: taxing land, not investment' (September 2018).

Taxing business property in this way also biases the system against certain sectors (like manufacturing) and regions (like the North and Midlands, where land values are generally lower). As the CPS has argued previously, a reform to **base business rates solely on underlying site values** would boost investment and growth, while cutting bills for manufacturing firms and 'left-behind' high streets.[7]

The property market

The Chancellor's stamp duty holiday has had a profound effect on the property market, boosting sales by 140 percent – bringing transactions to their highest level since before the financial crisis, and preventing a collapse in the housebuilding sector.[8] To end the stamp duty holiday now would be an enormous mistake, jeopardising our economic recovery and deepening our housing crisis.

There are reports that the Chancellor intends to extend the stamp duty holiday for three months. This is welcome news. However, as we argued in a recent CPS paper, there is a very strong case to go further and **make the stamp duty holiday permanent**. Stamp duty is an extraordinarily bad tax that wreaks havoc on the property market. Raising the threshold to £500,000 would put almost 90 percent of primary home sales outside the stamp duty net altogether. The Chancellor should also consider **cutting the marginal tax rates for primary residences above that threshold** – we have suggested 4 percent on the value between £500,000 and £1 million and 5 percent beyond that.

On a static basis, raising the threshold and lowering rates above it would cost £3 billion a year. However, the flip side of stamp duty being such a distortive tax is that getting rid of it will likely produce strong dynamic effects – as evidenced by the stamp duty holiday itself. Since there is a strong relationship between transaction volumes and new-build construction, it would also boost housing supply.

Our analysis suggests that through a mixture of increased transactions, greater non-SDLT revenue related to property sales, higher receipts from housebuilding levies, and less money being needed to subsidise affordable housing, the real fiscal cost would only be about £500 million per year. At that price, radically reforming stamp duty should be considered a bargain.

The Longer-Term Trajectory: What Not to Do

As mentioned above, the Chancellor's main focus on Wednesday will be on the immediate priorities of the coronavirus. Yet he can, and should, also take the opportunity to set out a longer-term vision.

Sadly, much of the speculation in the run up to the Budget has focused on various tax increases that are supposedly under consideration in the Treasury. Owing to the Conservative Party's election manifesto commitment not to raise income tax, National Insurance, or VAT, these mostly cover business and investment.

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[7] See Tom Clougherty et al., 'A Framework for the Future: Reforming the UK Tax System,' Centre for Policy Studies & Tax Foundation (November 2020), pp. 56–58.

[8] Jethro Elsden, 'Don't Hike Stamp Duty,' Centre for Policy Studies (February 2021).

This is doubly unfortunate. For one thing, as outlined above, **now is simply not the time for a tax-raising agenda**: the best way to improve the government's fiscal position is to get the economy growing again, as quickly and as robustly as possible. Raising taxes now would risk undermining, or at least dampening, the economic recovery. (This is before you consider the strong economic evidence that cutting spending is a less damaging approach to fiscal consolidation and debt reduction than raising taxes.[9])

Yet even worse than a general tax-raising agenda is giving the specific impression that business, in particular, must be made to pay for the pandemic.

Years of uncertainty over Brexit have already put a dent in Britain's hard-won reputation as a business-friendly, investment-friendly nation. As the CPS has made clear elsewhere, we need the private sector to be an engine of growth and recovery. We need businesses and investors to want to come to the UK, or expand their operations here.

With this in mind, **signalling to businesses and investors that years of tax increases are on the horizon would be precisely the wrong course**.

There are also specific problems with each of the tax increases that have been trailed in the press, which we will address below.

Raising corporation tax

The latest suggestion is that the Chancellor plans to increase the headline rate of corporation tax over the rest of the parliament, so that it reaches 23 per cent (up from 19 per cent) by the next general election, or perhaps even 25 per cent.

Such a move is likely to prove a drag on growth. Research by the OECD suggests that corporation tax is the most damaging major tax when it comes to GDP per capita.[10] It is also likely to lead to lower wages and investment, especially when future increases are telegraphed in such a fashion. Economists at Oxford University have found that about half of every £1 increase in corporation tax ultimately falls on wages.[11]

It is also a big mistake to assume that Britain's corporate tax system is exceptionally competitive just because the headline rate is low by international standards. We have the fourth lowest rate of corporation tax in the OECD, yet the Tax Foundation's International Tax Competitiveness Index ranks us only 17th out of 36 for our corporate tax regime as a whole, largely because our approach to capital cost recovery (which covers things like investment allowances and loss provisions) is so stingy.[12] As we showed when the latest edition was published, increasing the corporation tax rate to 24 per cent would see us drop to 25th place on that index. Increasing CGT and dividend taxation to

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[9] Alberto Alesina et al., 'Climbing Out of Debt,' *Finance & Development* 55:1 (March 2018).

[10] Asa Johansson et al., 'Tax and Economic Growth,' OECD (July 2008).

[11] Wiji Arulampalam et al., 'The Direct Incidence of Corporate Income Tax on Wages,' Institute for the Study of Labour (October 2010).

[12] Daniel Bunn and Elke Asen, 'International Tax Competitiveness Index 2020,' Tax Foundation (October 2020).

match taxes on labour, as discussed below, would see our rating for personal taxation drop from 24th to 36th – the worst in the OECD. And doing both together would see our overall rating fall from 22nd to 30th.[13]

An excess-profits tax

It has been reported that the Government may impose a windfall levy on those firms that are perceived to have profited most from the pandemic. Yet **attempting to single out firms that have performed well during the pandemic and apply a retrospective tax would rip up the principles of good tax policy** and send an unmistakable message that, far from being open for business, the British government was actively hostile towards commercial success. Businesses that have made money over the last 12 months have done so by meeting consumer needs at a particularly challenging time. The profits they have made will be subject to corporation tax in the ordinary way. There is no economic justification for anything further than that.

An online sales tax

The government is allegedly considering the introduction of an online sales tax, which would be justified as a way to 'level the playing field' between online retail and the British high street. In reality, such a policy would simply burden consumers – especially vulnerable ones who need to have goods brought to them at home – while doing very little to change the economics of town-centre retail. Any reform in this area should **focus on helping retailers compete, in particular via business rates reform, rather than punishing online firms**.

Higher capital gains tax and dividend tax rates

The Chancellor is rumoured to favour the alignment of capital gains/dividends and income tax rates. That would imply doubling the standard rate of capital gains tax for basic and higher rate taxpayers, more than doubling it for additional rate taxpayers, and perhaps even increasing the tax paid by successful entrepreneurs when they sell their business by 450 percent (depending on whether and to what extent business asset disposal relief was maintained). It would also take Britain from having a broadly competitive CGT regime internationally to having the highest top rate of tax on shares of any country in the OECD. For all this, it's not clear that rate-alignment would raise that much money – CGT is a fairly minor tax in the grand scheme of things, and previous CPS research (based on the Government's own figures) suggested that the revenue-maximising rate was around 28 per cent.[14] **Hiking capital taxes would do significant damage, for very little benefit.**

The desire to tax labour and capital income equally is understandable, but capital gains tax is a problematic tax at the best of times. Taxing the sale of an asset *as well as* the earnings that give rise to an asset's price is a form of double taxation. Taxing the returns to saving *as well as* the income that is saved is another. Both discourage investment and therefore hinder growth. Capital gains tax also creates a 'lock-in' effect – people delay selling an asset to avoid realising a gain – that distorts the allocation of capital and mitigates against serial entrepreneurship, reducing economic

[13] Tom Clougherty, 'Wrong Taxes, Wrong Time: The Case against Taxing Business,' Centre for Policy Studies (October 2020).
[14] Howard Flight and Oliver Latham, 'The case against CGT,' Centre for Policy Studies (September 2012).

dynamism. Significantly raising CGT rates would compound these problems. It would also be a signal to internationally mobile investors that they might be better off looking elsewhere.

None of this is to rule out some reform of the CGT system. We could certainly **police the boundary between ordinary earnings and capital gains better**, so that lower tax rates are only accessible to genuine investors and entrepreneurs. And we could **rethink certain features of CGT (like the relatively high annual allowance) that are clearly used primarily for tax planning purposes**, rather than serving any clear economic objective. But to simply hike CGT rates would be a clear step in the wrong direction.

How to Deliver Growth

Having outlined what the Chancellor should not do, this final section will set out how he can outline a positive, pro-growth agenda for the remainder of the parliament. With the vaccine rollout proceeding successfully, and a clear pathway out of lockdown now established, this is how he can deliver a glimpse of those long-awaited 'sunlit uplands'.

Full expensing

Permanent reform of stamp duty and rapid progress on a pro-growth overhaul of business rates (both outlined above) would be a great start. Another big productivity-boosting reform would be **the introduction of 'full expensing'** – the immediate deduction of capital investment for corporation tax purposes. This reform probably has the potential to do more for UK economic growth than any other potential tax change.

Previous CPS research has suggested a number of different ways that full expensing could be put into effect.[15] One option is to make the temporary £1m Annual Investment Allowance (AIA) permanent, while introducing 'neutral cost recovery' for any additional investment in plant and machinery, as well as investment in structures and buildings.[16]

The second option is to make the Annual Investment Allowance *unlimited*, so that all investment in plant and machinery can be immediately deducted, while applying the neutral cost recovery approach to the Structures and Buildings Allowance.

The third and most radical option would be to put corporation tax onto a pure cashflow basis – so that the tax base became simply the difference between corporate revenues and corporate expenses (including all forms of investment). This approach, which would be similar to reforms adopted in Estonia and Latvia, would also allow for a very significant simplification of the tax code.

[15] See Centre for Policy Studies, 'A Budget for No Deal' (March 2019); Stephen J. Entin, 'Boosting Growth as the UK Leaves the European Union,' Centre for Policy Studies (March 2020); and Tom Clougherty et al., 'A Framework for the Future: Reforming the UK Tax System,' Centre for Policy Studies & Tax Foundation (November 2020).

[16] Neutral cost recovery would mean uprating outstanding investment costs (i.e., ones that have not yet been deducted) annually, so that they hold their economic value over time.

The problem with the third option, and to a lesser extent the second one, is that the up-front revenue cost would be very large – running to the tens of billions in year one. However, revenue costs would fall dramatically over time (the initial 'sticker shock' is down to writing off all *new* investment right away, while still writing off old investment costs under the legacy system) and could easily be outweighed in the longer term by the growth effects such reform would generate.

The most competitive tax regime in the G20

Alongside specific immediate measures, it would also be helpful to set a long-term direction for tax policy and pick a reference point against which further reforms can be assessed. Such an approach would give businesses and investors (not to mention voters) a degree of certainty about the path of policy over the parliament and send a clear signal about the kind of country the Government wants Britain to be.

We therefore urge the Chancellor to take a leaf out of the Coalition's book and state a **clear and unambiguous ambition to ensure that Britain has the most competitive tax regime in the G20**. This shouldn't just apply to business taxes, but to the tax code as a whole. And it wouldn't be about the size of the tax burden, but rather about the quality of the tax system – whether it manages to avoid high effective marginal tax rates that undermine enterprise, whether it eliminates distortionary features that affect economic decision-making, and, more broadly, how well it supports private sector growth and attracts investment.

A long-term, balanced approach to deficit reduction

As noted above, any immediate fiscal tightening is entirely unnecessary – not least because significant tax increases will likely cut the legs out from under our economic recovery.

That doesn't mean that fiscal conservatism is yesterday's news, and that there is no longer the need for any kind of restraint. On the contrary: the UK still faces major fiscal sustainability issues in the long run, as an ageing population puts ever-increasing pressure on the welfare state. What's more, ensuring that public funds are spent efficiently is a task that needs constant focus from the Treasury – no one wants to see waste, or public spending crowding out the private sector.

But right now, **the biggest economic challenge on the Chancellor's plate isn't balancing the books; it's getting the economy growing again**. And not just at the paltry rates we've seen since the financial crisis – **we need to get the growth rate up, and that means getting individuals and businesses to invest in future productivity**, as outlined above.

Once the economy is growing strongly, the Treasury should adopt a balanced approach, keeping tight controls on public spending (the CPS recently identified £30bn of annual savings that could be implemented without hitting frontline services[17]) while also seeking to raise any necessary funds in the least economically damaging way possible.

[17] Centre for Policy Studies, 'Saving £30 Billion: 9 Simple Steps' (October 2020).

That might mean reforming council tax (which is still based on property values from 1991), improving VAT (our tax base is the narrowest in the developed world), overhauling environmental taxation (with a straightforward carbon tax to replace myriad levies, subsidies, and regulations), or finally getting to grips with congestion (a shift from fuel duty to dynamic road pricing will be essential as we transition to electric vehicles). It might also mean a simplified, ISA-based framework for all forms of lifetime saving, as well as some form of 'pre-funding' for old-age health and social care.

Conclusion

As the 2021 Budget approaches, Britain is at a crossroads. Brexit is behind us, even if some of the details are still being ironed out. And while the Covid-19 pandemic is still ongoing, the end is at least in sight.

In this context, the Chancellor's immediate priority should be to maintain support for the wider economy. Having come this far, the last thing we want is to plunge over a series of cliff-edges that cost jobs, spark business closures, or collapse the property market.

But he also needs to set out a long-term vision for the economy, even if the big reforms are left for further down the line. This means rejecting rumoured tax increases on business and investment, which would only undermine growth, and instead charting a clear course towards an increasingly competitive tax system.

Concern about the health of the public finances is laudable, but the truth is that there is little to worry about right now. Putting the deficit first would be a huge and easily avoidable mistake. There will be a time for fiscal conservatism, but for now the overriding objective must be to go for growth – and support the private sector to deliver the recovery we sorely need.

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