Wrong Taxes, Wrong Time

The Case against Taxing Business

by Tom Clougherty

- The Treasury is reportedly considering increases in Corporation Tax and Capital Gains Tax in order to plug the tax gap left by the pandemic
- But the immediate need is to focus on growth and recovery – and raising taxes on productive investment, now or in the future, would damage the economy in the longer term
- Analysis by the Centre for Policy Studies and the US-based Tax Foundation shows that our business tax regime, despite the low headline rates, is not as competitive as we think. Increasing Corporation Tax would put us at a significant international disadvantage
- The reported proposal to align dividend tax and Capital Gains Tax rates with Income Tax would leave us with the second-highest top rate on dividends and the highest top rate on capital gains for shares in the OECD.
- Implementing all of the reported tax increases would see the UK drop to 30th out of 36 on the Tax Foundation's International Tax Competitiveness Index – down from 22nd today.

According to reports, the Treasury is considering a range of potential tax increases intended to help close Britain's budget deficit. The mooted increases include raising the corporation tax rate from 19 per cent to 24 per cent and aligning capital gains and dividend tax rates with those on ordinary income.

This briefing will explain why those particular proposals are flawed. But it is also worth making a more fundamental point – that even if you view a tax-raising agenda as necessary, now is certainly not the time.

The Covid-19 pandemic, and the necessary economic response to it, have wrought havoc on the government's budget deficit. But trying to close the fiscal gap *now*, in the midst of enormous economic uncertainty, and with a post-Brexit trade deal hanging in the balance, would be an act of self-sabotage.

What's more, when the time *does* come to bring down the deficit significantly, the last way the Government should do it is by raising taxes on productive investment. Whatever short-term revenue boost such measures yielded would likely be outweighed in the medium term by a drag on economic growth. Britain cannot afford to take its tax competitiveness for granted.

Corporation Tax

The Treasury is rumoured to be considering an increase in the corporation tax rate from 19 per cent to 24 per cent. This would come on top of scrapping the planned fall in the corporation tax rate from 19 to 17 per cent, which was supposed to take effect in 2020.

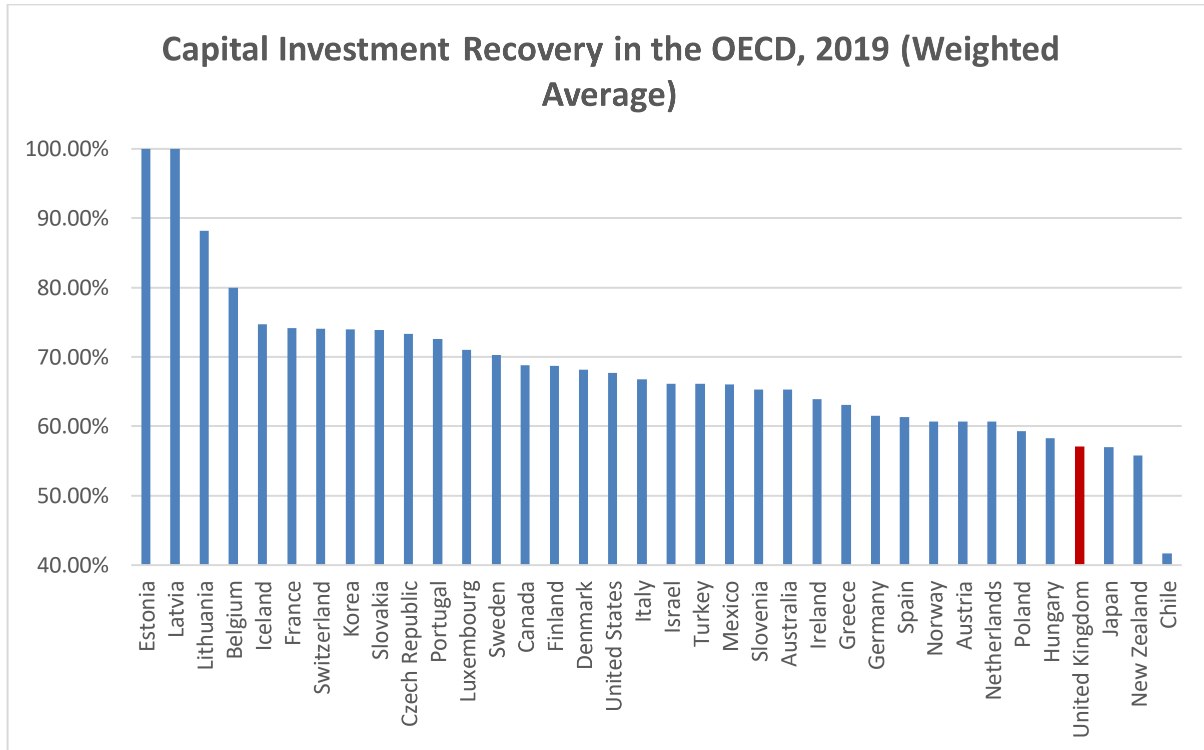
The rationale seems to be that 24 per cent is the global average and is still lower than some of Britain's main competitors – so raising the tax rate shouldn't do too much harm. On the other hand, it would "raise £12bn next year, rising to £17bn in 2023-24".[1] Unfortunately, this argument is flawed.

Research by the OECD suggests that corporate income taxes are the most damaging type of tax when it comes to GDP per capita.[2] Raising corporation tax *now*, as we try to emerge from a global pandemic, while also negotiating a new relationship with our biggest trading partner, would surely be a masochistic move. We have enough economic headwinds to contend with, without deliberately adding another one.

Secondly, Britain's existing corporate tax system isn't nearly as competitive as we think it is. We might have one of the lowest headline tax rates, but tax is about more than just headline rates. Taking a more holistic view, the Tax Foundation in the US suggests that the UK's corporate tax system is only the 17th most competitive in the OECD – and that when it comes to our tax treatment of corporate investment, we rank close to last.[3]

We might levy a relatively low tax rate on profits, but we are also extremely stingy about letting companies write off their investment costs against tax. The problem will only get worse if the Annual Investment Allowance, which allows the immediate deduction of qualifying capital investment, falls from £1 million to £200,000 at the end of the year as planned. None of this is good news in a country that already has a longstanding weakness when it comes to business investment.[4]

Given our poor treatment of capital investment, adopting an "average" headline rate would leave us with a distinctly below-average corporation tax overall. In fact, our corporation tax ranking on the Tax Foundation's International Tax Competitiveness Index would fall from 17th to 25th (out of 36). That sort of deterioration in policy is bound to drive away business, investment, and – ultimately – jobs.



Source: Elke Asen, "Capital Cost Recovery across the OECD", Tax Foundation, Apr. 8, 2020, https://taxfoundation.org/publications/capital-cost-recovery-across-the-oecd.

It is also worth bearing in mind that corporations themselves can't really pay tax – the burden must ultimately fall on investors (in the form of lower returns), customers (in the form of higher prices), and employees (in the form of lower wages). In a competitive, globalised economy (where capital is mobile and the consumer is king) it is likely that employees will lose out: a study by economists at Oxford University's Centre for Business Taxation looked at data from 55,000 companies across Europe, and found that 49p of every £1 increase in corporation tax ultimately falls on employees.[5]

Finally, it is worth questioning whether a five percentage point increase in corporation tax would generate as much revenue as the Treasury seems to expect, given the challenging economic situation we find ourselves in. Industry as a whole is struggling, and many businesses will have significant pandemic-induced losses to write off against any profits in the years ahead. Corporate tax revenues tend to be quite responsive to the economic cycle and were already down more than 40 per cent in April–July.[6] It is obviously hard to predict future tax revenues in the face of such economic uncertainty, but only a very optimistic policymaker could assume bumper returns from a corporation tax rise this year.

Dividends and Capital Gains Tax

The Treasury is also supposedly looking at aligning the tax rates on dividends and capital gains with those on ordinary income. That would be a big change from the current system, which looks like this:

	Income	Dividends	Capital Gains
Basic rate	20%	7.5%	10% (18%)
Higher rate	40%	32.5%	20% (28%)
Additional rate	45%	38.1%	

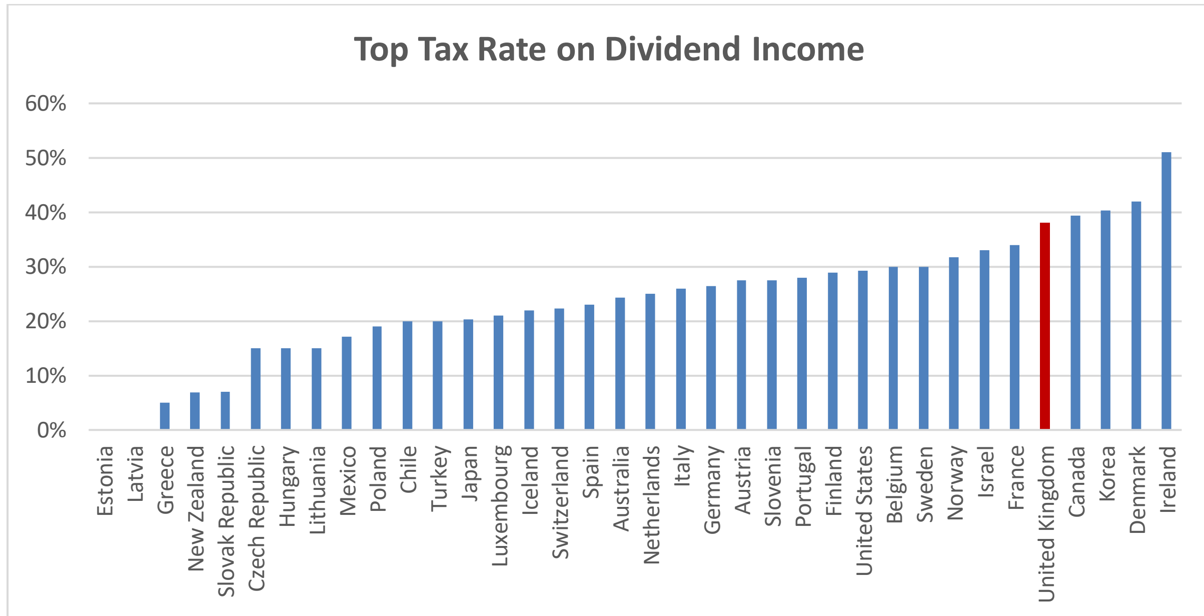
N.B. The higher capital gains tax rates apply primarily to gains from residential property. The tax-free annual allowance for dividends is £2,000; for capital gains it is £12,300.

A lot of people see the lower tax rates on dividends and capital gains and perceive it as a source of unfairness in the tax system. Why, they ask, should investors be taxed more lightly than ordinary workers? Yet this represents a misunderstanding of the tax system: despite those lower rates, the tax system is actually biased *against* investment, because the income it produces is taxed at both the corporate *and* the individual level.

Take dividends first. Let's say that £100 of profit is subject to corporation tax at 19 per cent, and then dividend tax at 38.1 per cent. The net income received by the investor is just £50. This means that corporate income is taxed more heavily than the same amount of personal income would be. (Indeed, the UK already levies one of the highest top marginal rates on dividends in the OECD.[7])

What about capital gains? There is an argument that taxing capital gains *at all* is a form of double-taxation – at least when it comes to business assets – because tax is already paid on the flow of earnings that gives rise to a share's capital value. (Shares were the source of nearly 80 per cent of all chargeable gains in 2017/18.[8])

Meanwhile, personal investments are very often made out of ordinary earnings that have already been subject to tax. Taxing the income or gains from investment *as well* creates a bias towards current consumption over future consumption and mitigates against long-term saving. There's also the issue of inflation: unless capital gains are properly indexed (which can be a complex task) people may end up paying tax on purely paper gains, and unfairly losing money on their investments overall.



Source: Daniel Bunn and Elke Asen, 2020 International Tax Competitiveness Index, Tax Foundation, Oct. 14, 2020, https://taxfoundation.org/publications/international-tax-competitiveness-index.

It is also important to consider capital gains tax from the perspective of entrepreneurs – they are, after all, the lifeblood of a vibrant economy. Raising capital gains tax rates will discourage people from starting businesses, make successful start-ups harder to scale up (the stock options widely used to attract talent are far less appealing if CGT rates are high), and also mitigate against *serial* entrepreneurship – innovative risk-takers selling established businesses so they can move on to new projects. Raising capital gains tax is thus a strike against economic dynamism and is likely to diminish national prosperity in the long run.[9]

The current Government has already slashed Entrepreneurs' Relief, reducing the lifetime gains eligible for a 10 per cent tax rate from £10 million to £1 million. To follow this by doubling the tax rate levied on any gains in excess of that allowance would send a pretty striking message to existing entrepreneurs and aspiring ones: that Britain isn't really interested in what you have to offer. The market for good ideas is global, and a 45 per cent capital gains tax would give us the highest rate (on shares in listed companies) anywhere in the OECD.

Needless to say, sharp hikes to capital gains and dividend tax rates would have a significant impact on the UK's international tax competitiveness. In fact, in the absence of offsetting pro-growth measures, aligning capital gains and dividend tax rates with those for ordinary income would leave the UK in *last* place for personal taxes on the Tax Foundation's International Tax Competitiveness Index. That's 36th out of 36 OECD countries – down from 24th place today. If this was coupled with higher corporation tax, the UK's *overall* tax competitiveness ranking would drop from 22nd to 30th.

Of course, from the Treasury's perspective, the most compelling argument against raising capital gains tax is simply that hiking tax rates won't necessarily produce much extra revenue, even in the short term. Capital gains tax is known to produce a strong "lock-in effect", whereby people hang on to their assets in order to defer or ultimately avoid tax liability. The last time they looked at this issue, the Treasury concluded that 28 per cent was the revenue-maximising rate for capital gains tax.[10] There's little reason to believe things would be different today.

Finally, some have suggested that the Treasury's motivation in raising capital gains tax rates is to close the so-called "carried interest loophole", which allows partners in private investment funds to pay lower (CGT) tax rates on part of their income. There are separate arguments to be had about whether carried interest is better treated as ordinary or investment income, and indeed about whether higher tax rates might prove counter-productive in revenue terms, by discouraging funds from basing themselves in the UK. But in any case, if the Treasury wants to target carried interest, they can do so directly (carried interest is already taxed at the higher, 28 percent CGT rate). There is no need for any wider alignment of capital gains tax rates with those on ordinary income.

A Better Way Forward

In the long term, there is plenty of work to be done improving Britain's tax system – including, if necessary, coming up with ways to raise revenue that have less impact on our tax competitiveness. But the best initial step is to, first, do no harm. The Government should resist calls to raise taxes in the short term. It should focus on growth. And in so doing, it should seek to reassure industry, investors, and entrepreneurs alike that Britain is – and will remain – very much open for business.

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[1] Tim Shipman, “Coronavirus: Rishi Sunak plans triple tax raid on the wealthy”, The Sunday Times, Aug. 3, 2020, https://www.thetimes.co.uk/article/coronavirus-rishi-sunak-plans-triple-tax-raid-on-the-wealthy-2wlqpq9v6.

[2] Asa Johansson et al., “Tax and Economic Growth”, OECD, Jul. 11, 2008, https://www.oecd.org/tax/tax-policy/41000592.pdf.

[3] Daniel Bunn and Elke Asen, 2020 International Tax Competitiveness Index, Tax Foundation, Oct. 14, 2020, https://taxfoundation.org/publications/international-tax-competitiveness-index.

[4] See, for example, Office for National Statistics, “An analysis of investment expenditure in the UK and other Organisation for Economic Co-Operation and Development nations”, May 3, 2018, https://www.ons.gov.uk/economy/grossdomesticproductgdp/articles/ananalysisofinvestmentexpenditureintheukandotherorganisationforeconomiccooperationanddevelopmentnations/2018-05-03.

[5] Wiji Arulampalam et al., “The Direct Incidence of Corporate Income Tax on Wages”, Institute for the Study of Labour, Oct. 2010, http://ftp.iza.org/dp5293.pdf.

[6] HM Revenue & Customs, Tax and NIC receipts: statistics table (July 2020), https://www.gov.uk/government/statistics/hmrc-tax-and-nics-receipts-for-the-uk.

[7] Only four out of 36 OECD countries currently have a higher top rate than the UK: Canada (39 per cent), Korea (40 per cent), Denmark (42 per cent), and Ireland (51 per cent).

[8] HMRC, Capital Gains Tax statistical tables, Table 7: Estimated number of taxpayer disposals, value of disposals and chargeable gains by asset type, 2017-18, https://www.gov.uk/government/statistics/capital-gains-tax-statistical-tables.

[9] One study of the link between capital gains tax and entrepreneurship found that cutting CGT from 20 per cent to 0 per cent improved national welfare even if only the top 1 per cent of successful entrepreneurs directly benefited – this is because the lower tax rate encourages more people to start new businesses. See V. V. Chari et al., “Business Start-ups, The Lock-in Effect, and Capital Gains Taxation”, Feb. 2005, http://www.dklevine.com/archive/refs4506439000000000222.pdf.

[10] See Howard Flight and Oliver Latham, “The case against CGT”, Centre for Policy Studies, Sep. 13, 2012, https://www.cps.org.uk/research/the-case-against-cgt.