Permanent Full Expensing

By Karl Williams & Tom Clougherty

Summary

- The Chancellor should make full expensing permanent at the forthcoming Autumn Statement. Doing so would raise long-run investment, and so increase real wages and economic growth.

- Permanent full expensing is a vital step in counteracting Britain's chronically low rate of capital investment, which was 20% lower than the OECD average in the decade before the pandemic.

- Previous research by the CPS and the Tax Foundation has suggested that making the current version of full expensing permanent would boost the long-run capital stock by 1.5%, and deliver a 0.8% boost to wages and a 0.9% boost to GDP. Other, more generous versions of the policy would have even more beneficial effects.

- Temporary full expensing, by contrast, will tend to change the timing of investment rather than the overall amount, with firms bringing plans forward to gain from favourable tax treatment.

- Despite the high short-term cost, the long-run fiscal cost of permanent full expensing is relatively low at around £1.4 billion per annum, and would be substantially offset by the economic benefits it would produce.

- Looking further ahead, the government should build on the success of full expensing by extending the same principle of 'tax neutrality' to a wider range of investments, including structures and buildings as well as all plant and machinery, potentially boosting GDP by 3.4%.

1. What is full expensing?

'Full expensing' refers to the ability of businesses to write off capital investment costs against corporation tax immediately and in full, rather than having to spread the tax deduction over time.

Full expensing is often described as an 'investment incentive'. And, indeed, it does improve investment incentives compared with the alternative. Strictly speaking, however, the point of full expensing is to achieve neutrality – to ensure that business investments are treated in the same way for tax purposes as day-to-day spending.

The problem with traditional capital allowances, which allow businesses to deduct a certain percentage of investment costs each year, is that the more you spread out a tax deduction, the less valuable it becomes. Factor in inflation and the time value of money, and businesses end up recovering far less than the full cost of their initial investment.

This embeds a structural distortion within the corporation tax system that reduces the return to capital and discourages business investment. The purpose of full expensing is to remove this distortion.

2. Low levels of business investment have held back UK growth and living standards

Britain has long had an investment problem. This matters because over the long run, business investment is a key factor in productivity growth – which in turn is the key driver of economic growth and rising living standards.

While most developed countries have experienced a productivity slowdown in recent years, the problem has been particularly acute in the UK. Measured in terms of output per hour worked, productivity increased by just 0.6% per annum in the decade to 2019 – less than a third of the long-run average rate.[1] Largely as a result, GDP per capita is only 6% higher now than in 2007.[2]

Low levels of business investment have undoubtedly been a major factor in stagnant living standards. In the decade between the financial crisis and the pandemic, gross-fixed capital formation (GFCF) in the UK averaged just 17% of GDP, well below the OECD average of 21% and behind G7 peers like Germany (20%) and France (22%).[3]

In turn, our relatively uncompetitive tax system is a key factor in explaining low investment levels.

True, George Osborne did make the UK a more attractive place to do business, gradually reducing the headline rate of corporation tax from 28% to 19%, with further cuts planned. But he paid for this in large part by slashing business investment allowances. This meant that the effective rate of corporation tax, i.e. the proportion of their profits companies actually paid in tax, remained essentially unchanged during his time as Chancellor. In fact, by the end of his tenure his various business tax rises were making back as much money as his corporation tax cuts were costing.[4]

Cutting corporation tax while cutting allowances meant that our tax system became more hostile to business investment, benefiting capital-light firms in the services sector at the expense of more capital-intensive activities such as manufacturing or R&D.

Before the introduction of the super-deduction in 2021, the UK tax system ultimately allowed only 62% of investment costs to be deducted – on a net present value basis – for machinery, industrial buildings, and acquired patents.

Research carried out by the Tax Foundation found that this put us in the bottom third of OECD countries overall.[5] And compared with other countries, we were particularly stingy when it came to investment in machinery and industrial buildings. This meant that despite a low headline corporation tax rate (then 19%), our business tax regime was neither as internationally competitive nor as pro-growth as it could have been.

Recent years, though, have seen a big improvement on this front – at least when it comes to plant and machinery. The Annual Investment Allowance (AIA), which allows businesses to 'fully expense' a limited amount of investment in plant and machinery each year, was raised from £200,000 to £1 million at the beginning of 2019. This began as a temporary measure, but was made permanent from April 2023.

From April 2021 to March 2023, the 'super-deduction' meant that most investment in plant and machinery received a 130% tax deduction in the first year. Then, in April this year, the Government introduced its version of full expensing – a 100% first year deduction for most investment in plant and machinery. (In both cases, longer-lived or 'special rate' investments are only eligible for a 50% first year deduction, with the remainder written down over time.)

Unfortunately, improvements to the tax treatment of investment have gone hand in hand with a much higher headline corporate tax rate of 25%.

In an ideal world, as the Centre for Policy Studies has repeatedly argued, we would have a low headline rate *and* full expensing.

Nonetheless, our research with the Tax Foundation suggested that the negative effects of the higher corporation tax rate could be mitigated by the positive effects of full expensing. We estimated that raising corporation tax from 19% to 25% would result in a long-run GDP hit of 1.2%.[6] However, we subsequently showed that the version of full expensing adopted in the Spring Budget, under the current corporation tax regime, would result in a long-run GDP improvement of 0.9%. Adopting a more expansive version of full expensing, applying to all plant and machinery, would increase this to 1.2% – while incorporating structures and buildings would have even more beneficial effects.[7]

However, all of these gains would only apply if full expensing were put on a permanent footing. As things stand, the current policy is set to expire at end of March 2026. The Chancellor has repeatedly stressed that he hopes to make the policy permanent. We strongly urge him to do so, for the reasons we set out below.

3. The impact of full expensing so far has been positive – but limited by its temporary nature

A wealth of academic studies show that generous capital expensing regimes have a track record of increasing business investment and hence productivity, wages and economic growth across a range of economies – including the UK, USA, China and Estonia, among others.[8]

There is also good evidence that the 'super-deduction' boosted business investment over the course of the 2022-23 tax year. We have to be careful about disentangling the effects of the post-pandemic rebound, but a survey by the CBI found that a fifth of business investment while the super-deduction was in place was contingent on the measure, and another fifth was brought forward because of it.[9]

However, the CBI's survey also shows the limitation of the full expensing when not put on a permanent footing – that fifth of investment which was brought forward.

A temporary policy may cause businesses to accelerate planned investment, but it is not likely to deliver the sort of lasting increase in investment levels that would boost productivity and growth.

The system of full expensing introduced by the Chancellor in April 2023 was also a temporary policy, albeit lasting for three years instead of two. And while it is too soon to fully measure the effects, the early signs are reasonably encouraging.

As Jeremy Warner of the Telegraph has pointed out, since the introduction of the super-deduction, Britain has enjoyed the fastest growth in business investment in the G7 (albeit from a low base).[10] Yet on the other hand, the temporary nature of both the super-deduction and then full expensing means that they have been nowhere near as effective as they could be.

4. Making full expensing permanent would boost investment and economic growth

Previous research by the CPS and the Tax Foundation suggests that making the current version of full expensing permanent would boost the long-run capital stock by 1.5%, and deliver a 0.8% boost to wages and a 0.9% boost to GDP.[11]

Other people's findings are even more positive. For example, modelling by Oxford Economics and the CBI found that if full expensing was made permanent, it could lead to a 20% increase in the annual flow of business investment in the UK by 2030/31, boosting GDP by about 2%.[12]

Of course, the Chancellor will still be worried by the cost to the Treasury, given how narrow fiscal headroom has been since last November. In March this year, the OBR estimated the up-front fiscal cost of full expensing at around £10 billion per annum.[13] Similarly, our analysis with the Tax Foundation found that, with the headline rate of corporation tax at 25%, the up-front, peak cost of the Government's version of full expensing would be around £11 billion.

But the fiscal picture looks a lot more encouraging if we take the long view. Our modelling found that the long-run costs of full expensing, if put on a permanent footing, would be around £1.4 billion per annum. In a similar vein, recent modelling by the Institute for Fiscal Studies (IFS) found that if made a permanent feature of the tax system, the cost of full expensing will actually quickly level out at between £1 billion and £3 billion per annum, as most of the up-front cost will be recouped in future years.[14]

In fact, our analysis was necessarily a static one. Once you take account of the additional business investment and economic growth – and so tax revenues – generated by the policy, it is plausible that the long-run effect of making full expensing permanent could be a net positive for the Treasury.[15]

Importantly, this policy measure would not undermine the Government's inflation-busting agenda – indeed, if anything, it could have a disinflationary effect by boosting the supply side of the economy.

Ultimately, making full expensing permanent would be a win-win for businesses and the Treasury, not to mention workers, taxpayers and consumers.

5. Conclusion

We have already begun to see the benefits of full expensing. But to completely capture the economic and fiscal uplift, it should be put on a permanent footing. Doing so is vital if the policy is to sustainably boost investment and therefore drive long-run productivity growth – which is, of course, the goal.

Temporary full expensing, by contrast, will tend to change the timing of investment – with firms bringing plans forward to take advantage of favourable tax treatment – rather than the overall amount.

Looking further ahead, the Government should also build on the success of the current full expensing policy by extending the principle of 'tax neutrality' to a wider range of investments. As the IFS has pointed out, even with full expensing in place there remain a great many distortions in our corporate tax base.[16] This undoubtedly holds back our economic growth potential.

For example, if over the long run the UK were to move towards the CPS's preferred model of full expensing for plant and machinery, alongside neutral cost recovery for longer-lived investments such as in buildings and structures, this would increase the long-run capital stock by 5.7% while boosting wages by 3.0% and GDP by 3.4%.[17] The fiscal costs would obviously be higher – but the benefits would be truly dramatic.

For the time being, however, the Chancellor should use the forthcoming Autumn Statement to make full expensing a permanent feature of the tax system. It would be a signal that Britain is serious about investment and economic growth, and set us on the path towards greater prosperity.

Long-run impact of improved investment incentives

	GDP	Investment	Wages
Enhanced write down allowance rates	0.1%	0.2%	0.1%
40% first-year allowance	0.5%	0.8%	0.4%
20% additional first-year allowance	0.7%	1.1%	0.6%
Spring Budget 2023 'full expensing'	**0.9%**	**1.5%**	**0.8%**
Full expensing for plant & machinery	1.2%	2.0%	1.0%
Full expensing for plant & machinery and structures & buildings	3.4%	5.7%	3.0%

Source: Tax Foundation/CPS modelling

Endnotes

[1] ONS, 'Table 5: Annual Output per hour worked, Whole economy, Chained volume measure (CVM), Index (2019 = 100)', *Output per hour worked, UK* (24 October 2023). Link.
[2] ONS, 'Gross domestic product (Average) per head, CVM market prices: SA' (10 November 2023). Link.
[3] The World Bank, 'Gross fixed capital formation (% of GDP)' (accessed 12 November 2023). Link.
[4] R. Colvile & T. Clougherty, 'Does Britain Mean Business?', CPS (10 March 2023). Link.
[5] Tax Foundation, 'International Tax Competitiveness Index 2019' (2 October 2019). Link.
[6] T. Clougherty, K. Pomerleau & D. Bunn, 'After the Super-Deduction', CPS & Tax Foundation (September 2022). Link.
[7] R. Colvile & T. Clougherty, 'Does Britain Mean Business?', CPS (10 March 2023). Link.
[8] See for example: G. Maffini, J. Xing & M. Devereux 'The Impact of Investment Incentives: Evidence from UK Corporation Tax Returns', *American Economic Journal*, vol.11 (August 2019). Link. Y. Liu & J. Mao, 'How Do Tax Incentives Affect Investment and Productivity? Firm-Level Evidence from China', *American Economic Journal*, vol.11 (August 2019). Link. K. Pomerleau, 'What We Can Learn from the UK's Corporate Tax Cuts', Tax Foundation (7 June 2017). Link. S. Bowman 'Full Expensing: The Best Idea In Politics You've Never Heard Of', ASI (9 November 2017). Link.
[9] CBI, 'Why introducing a permanent investment deduction makes economic sense' (6 March 2023). Link.
[10] J. Warner, 'The tax allowance that could supercharge Britain's economy – if it's made permanent', *The Telegraph* (11 November 2023). Link.
[11] R. Colvile & T. Clougherty, 'Does Britain Mean Business?', CPS (10 March 2023). Link.
[12] CBI, 'Why introducing a permanent investment deduction makes economic sense' (6 March 2023). Link.
[13] OBR, 'Economic and fiscal outlook – March 2023', p.14. (15 March 2023). Link.
[14] IFS, 'Full expensing and the corporation tax base', *Green Budget 2023 – Chapter 10* (6 October 2023). Link.
[15] CBI, 'Why introducing a permanent investment deduction makes economic sense' (6 March 2023). Link.
[16] IFS, 'Full expensing and the corporation tax base', *Green Budget 2023 – Chapter 10* (6 October 2023). Link.
[17] R. Colvile & T. Clougherty, 'Does Britain Mean Business?', CPS, p.15. (10 March 2023). Link.